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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 890

RANDALL J. LeBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LeBoeuf, Lamb & Leiby,

Petitioners,

v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, a Corporation, Debtor,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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RANDALL J. LEBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LeBoeuf, Lamb & Leiby,

Petitioners,

v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, a Corporation, Debtor,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

Petitioners pray that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Fourth Circuit, affirming a judgment of the United States District Court for the Eastern District of Virginia ("the Reorganization Court"), entered in a proceeding under Chapter X of the Bankruptcy Act for the reorganization of the debtor, Central States Electric Corporation, a Virginia corporation. The Reorganization Court dis-

missed petitioners' application for the allowance and payment by the debtor of the reasonable expenses, including attorneys' fees, incurred by petitioners' assignors in the successful defense of a plenary suit brought by debtor's trustees against said assignors and others in the United States District Court for the Southern District of New York.

The Court of Appeals below affirmed the order of the Reorganization Court on the ground that the plenary suit in New York was founded upon substantive federal rights, not state-created rights, notwithstanding that the New York District Court (and this Court) had previously determined that the plenary suit was founded upon state-created rights, and that the New York statute providing for such allowances could not be applied in a federal bankruptcy court because it conflicted with the federal Bankruptcy Act.

Opinions Below

The opinion (by District Judge Chesnut) of the Court of Appeals for the Fourth Circuit (before Chief Judge Parker, Circuit Judge Soper and District Judge Chesnut), as at this date, has not been reported. It is printed in the Appendix to this petition at page 38.

The opinion of the United States District Court for the Eastern District of Virginia (the Reorganization Court) is not reported. It is printed at page 3 of the Appendix to petitioners' (appellants') brief in the Court of Appeals below.

Jurisdiction

Jurisdiction of this Court is invoked under Sec. 1254 (1) (62 Stat. 869) of the Judiciary Code. The judgment of the Court of Appeals was entered January 7, 1957.

Questions Presented

1) Is there any federal substantive law that creates a cause of action in favor of a state corporation against its former directors for alleged breaches of fiduciary duties occurring prior to and independently of a reorganization proceeding of such corporation under Chapter X of the Bankruptcy Act, which cause of action is enforceable in a plenary suit brought by the Chapter X reorganization trustee of such corporation?

2) Does the fact that jurisdiction of a plenary suit brought by a Chapter X bankruptcy trustee in a United States District Court is based upon Article I, Section 8, clause 4, of the Constitution and Section 2(a)(7) of the Bankruptcy Act (11 U.S.C. §11(a)(7)), operate to convert the basis of the plenary suit into one founded upon federal doctrines of general equity jurisprudence and thereby preclude the application in the Reorganization Court of a New York statute providing for reimbursement of litigation expenses of successful defendants?

3) Is there such a conflict between the provisions of Chapter X of the Bankruptcy Act and the provisions of a state statute, such as Article 6-A of the General Corporation Law of New York (22 McKinney's Consolidated Laws of New York, §64, *et seq.*) and the similar statutes of numerous other states, as noted *infra*, that the provisions of the federal Bankruptcy Act preclude application of the state statute?

CONSTITUTIONAL PROVISIONS AND STATUTES

Constitution of the United States, Article I, §8:

"The Congress shall have power * * *

"to establish * * * uniform Laws on the subject of bankruptcy throughout the United States; * * *

"to constitute Tribunals inferior to the supreme Court; * * *"

Constitution of the United States, Article III, §§1 & 2:

"Section 1.

"The Judicial Power of the United States, shall be vested in one supreme Court, and any such inferior Courts as the Congress may from time to time ordain and establish."

"Section 2.

"The Judicial Power shall extend to all Cases of Law and Equity arising under this Constitution, the Laws of the United States * * *"

Provisions of New York General Corporation Law:

Articles 6 and 6-A, §§60, 61, 64, 65, 66, 67 and 68 (22 McKinney's Consolidated Laws of New York Annotated, §§60, 61, 64, 65, 66, 67 and 68).

The pertinent text is set forth in the Appendix.

Provisions of the Bankruptcy Act:

Chapter II, §2(a)(2), (7), (15), (18), (b) (30 Stat. 545, as amend. 31 Stat. 85, 32 Stat. 797, 35 Stat. 838, 36 Stat. 838, 839, 44 Stat. 662, 52 Stat. 842, 66 Stat. 420).

The pertinent text is set forth in the Appendix.

Chapter X, §§102, 111, 221, 241, 242 and 243 (52 Stat. 883, 884, 897, 900).

The pertinent text is set forth in the Appendix.

Statement of the Case

Petitioners were attorneys for, and are the assignees of, two individuals, residents of New York, who were made parties defendant in a plenary action brought by the respondent (and his co-trustee, now deceased) in the United States District Court for the Southern District of New York (herein called "the New York action"). Respondent is the trustee of Central States Electric Corporation, a Virginia corporation, in reorganization proceedings under the provisions of Chapter X of the Bankruptcy Act (11 U.S.C.A. §501 *et seq.*) in the United States District Court for the Eastern District of Virginia (herein called "the Reorganization Court"). The petition for reorganization was filed on February 23, 1942.

Petitioners' assignors were made parties defendant in the New York action by reason of the fact that for respective periods, from January 6, 1926 to January 30, 1934, in the case of one assignor, and from March 6, 1928 to December 28, 1934 in the case of the other assignor, such assignors had been members of the board of directors of the debtor corporation which had an office and was doing business in New York.

The complaint in the New York action alleged that petitioners' assignors conspired with a controlling stockholder to mismanage the affairs of the debtor and otherwise neglect their duties as directors. The action was founded solely on alleged rights of debtor created by the laws of New York. All of the 13 separate transactions alleged in the complaint took place in New York.

No diversity of citizenship of the parties was alleged. Jurisdiction of the action was founded upon the provisions of Article I, Section 8, clause 4, and Article III, Section 2 of the Constitution of the United States and

the Bankruptcy Act, particularly Section 2(a)(7) (11 U.S.C.A. §11(a)(7)). The defendants' objection to the jurisdiction of the New York District Court over the action was sustained by the District Court (*Austrian, et al.* v. *Williams, et al.*, 67 F. Supp. 223). The Circuit Court of Appeals for the Second Circuit reversed (159 F. 2d 67) and this Court affirmed (*Williams, et al.* v. *Austrian, et al.*, 331 U. S. 642, June 16, 1947).

After a protracted trial, a final judgment on the merits was granted petitioners' assignors dismissing the action on the merits (*Austrian, et al.* v. *Williams, et al.*, 103 F. Supp. 64). In the final judgment entered March 7, 1952, the Court reserved jurisdiction for the purpose of permitting the parties to apply for further orders and directions "in connection with costs, expenses and allowances and with the enforcement, adjustment and satisfaction of this judgment and decree * * *." Plaintiff trustees did not appeal from such judgment or any part thereof.(1)

Thereafter, petitioners' assignors applied to the New York District Court for an assessment of their reasonable

(1) In the opinion below (A. p. 41) Judge Chesnut states that petitioners' assignors "did not appeal this decision". Obviously, the final judgment of dismissal having been in favor of petitioners' assignors no appeal from such judgment could have been taken by them. The opinion below also gives a distorted impression of the determinations made by the trial court as findings stated its opinion. The trial court found that plaintiffs failed to sustain their proof that defendants conspired to injure the debtor (103 F. Supp. 64, 75). Of the thirteen separate transactions, designated by the letters "A"-"M", inclusive, the trial court found that as to the important transactions "A", "B", "E", "F", "G", "H", "J", "K", "L" and "M", plaintiffs failed to prove any cause of action (103 F. Supp. 64, at pp. 70, 80, 84, 94, 98, 105, 107, 110). In respect of the alleged "findings" against petitioners', all of such "findings" were made "subject, however, to consideration of the defense of the statute of limitations" (103 F. Supp. pp. 92, 97, 101), and on such consideration the trial court held as to each of these transactions recovery against petitioners' assignors was barred (p. 117).

expenses, including attorneys' fees, incurred in the successful defense of the action, pursuant to Article 6-A, particularly Sections 64-68, of the General Corporation Law of New York (22 McKinney's Consolidated Laws of New York, §§64-68). No specific amount was requested. The verified petition of petitioners' assignors stated $75,000 as the reasonable amount of their attorneys' fees and disbursements of $1,185.53. The District Court granted the application and assessed the expenses in the amount of $31,185.53. The Court's order expressly directed that the enforcement of its order should be made only in the Reorganization Court (*Austrian, et al.* v. *Williams, et al.*, 120 F. Supp. 900, 907). The trustees appealed.

The Court of Appeals for the Second Circuit reversed the order of the New York District Court on the ground that the application for the assessment of the litigation expenses should be made to and could be determined only by the Reorganization Court (*Austrian, et al.* v. *Williams, et al.*, 216 F. 2d 278, 1954; cert. den. *Fogarty, et al.* v. *Austrian, et al., Trustees,* No. 550, 348 U. S. 953, February 28, 1955). The reversal by the Court of Appeals was expressly stated to be without prejudice to renewal of the application for reimbursement of the litigation expenses in the Reorganization Court (216 F. 2d 278, 283).

Thereafter, the rights to such reimbursement were assigned to petitioners and in December, 1955, petitioners applied to the Reorganization Court for allowances in their right as assignees of their assignors' rights under Article 6-A of the New York General Corporation Law and, alternatively, in petitioners' own right for allowances under the provisions of Chapter X of the Bankruptcy Act. After a hearing, District Judge Hutcheson dismissed the petition, holding in a short, unreported opinion that

the New York statutory provision was not binding upon the Reorganization Court and saying (A. below, p. 6):

> "* * * Upon the contrary, the rights of petitioners are to be determined in accordance with the principles applicable in Federal Courts without reference to the state law. * * *"

The Reorganization Court also held that no allowances could be made under Chapter X on the ground that the petitioners' services in the defense of the New York action were not a benefit to the debtor's estate. (The text of the opinion is printed in the Appendix to Appellants' Brief in the Court of Appeals below.)

Petitioners thereupon appealed to the United States Court of Appeals for the Fourth Circuit. That Court (Circuit Judges Parker, Soper and District Judge Chesnut), in an opinion by District Judge Chesnut, affirmed the order of the Reorganization Court, holding that the New York statute was not applicable, assigning as the principal grounds: (1) that the New York action "was an action based on the general principles of jurisprudence and * * * the jurisdiction of the District Court in New York was controlled by federal law * * *". Furthermore, the substantive right of action was in no way based on the authority of the particular New York statute [referring, aparently, to Sec. 60, Article 6 of the General Corporation Law of New York], which indeed in its fundamental aspects is merely a reflection but not a creation of the substantive equitable rights contained in equity jurisprudence." (A. p. 45) and (2) that "* * * it would be quite inconsistent with this important policy of Chapter 10 [of the Bankruptcy Act] to subject the judicial discretion of the Reorganization Judge to the absolute requirements of a particular State statute [§64,

General Corporation Law of New York] which could not possibly come into play except for the accidental fact that the defendants sued were subject to persona service only within the particular federal district * * *' (A. p. 48).

Reasons Relied on for the Allowance of the Writ

1) The Court of Appeals below has decided an important question of federal law, namely whether the provisions of the federal Bankruptcy Act preclude the applicability of state statutes creating a right to reimbursement for litigation expenses of directors and officers of state-created corporations in plenary suits brought by bankruptcy trustees. This is a question which has not been, and should be, settled by a decision of this Court.

2) The decision of the Court of Appeals below holding that the New York plenary suit was founded on federal substantive equitable rights or a federal rule of general jurisprudence and not on state-created rights is a decision on a federal question in a way which is in direct conflict with applicable decisions of this Court.

3) The Court of Appeals below has rendered a decision which is in conflict with the decision of other Courts of Appeals on substantially the same matter.

AMPLIFICATION OF REASONS FOR ALLOWANCE OF WRIT

POINT I

Contrary to the holding below, there is no conflict between any provisions of the Bankruptcy Act and the New York statute which created a substantive right to reimbursement for litigation expenses.

The New York statutory provisions included in Article 6-A of the General Corporation Law providing for reimbursement of the litigation expenses of corporation directors and officers in the successful defense of a plenary suit brought against them, were first enacted in 1941.[2] The purpose of the New York statute was to resolve a doubt regarding the common law of New York. (See Legislative Document No. 65, State of New York, Report of the Law Revision Commission for 1945, Subdivision E entitled "Act, Recommendation and Statute Relating to Reimbursement of Litigation Expenses of Corporate Officers", p. 131, particularly p. 139.) The statutes were revised and amended in 1945 and eventually incorporated as Article 6-A of the General Corporation Law (L. 1945, c. 869, §4).[3] The text of the statutes is printed in the Appendix, at pages 30-33.

The effect of the statute, particularly Section 64, was to make applicable to plenary suits against officers and directors of corporations the long existing practice under English law for an award of costs which include counsel

(2) 22 McKinney's Consol. L. of N. Y. Anno., c. 209, effective April 2, 1941, §§27a and 61a of the General Corporation Law.

(3) 22 McKinney's Consol. L. of N. Y. Anno., §§63-68.

fees of the successful party (Law Revision Report, *supra*, at p. 156).

The state statute is not contrary to any general federal policy. Several federal statutes grant to successful parties a right to attorneys' fees, *e.g.*, in suits under the Copyright Laws (61 Stat. 652, 17 U.S.C. §116); Interstate Commerce Commission Laws (34 Stat. 590, 49 U.S.C. §16 (2)); the Anti-Trust Laws (38 Stat. 731, 15 U.S.C. §15).

For many years state statutes have included provisions for awarding attorneys' fees in costs where a claim is established by plaintiff suing on an insurance policy or where certain types of small claims are successfully prosecuted (Nebraska Comp. Stat. 1922, §7811; Texas Rev. Stat. 1911, Arts. 2178-9). The validity of such state statutes and their application in a suit in the federal court have been sustained in this Court (*Sioux County* v. *National Surety Company*, 276 U. S. 238 (1938)).(4)

The policy of the reimbursement statutes is to induce capable men to assume corporate directorships and overcome the fear of having to defend groundless actions at their own expense. *Mooney* v. *Willis-Overland Motors*, 204 Fed. 2d 888, 898. Such statutes have been enacted in numerous states:

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(4) For other studies of reimbursement of litigation expenses of corporation officers and directors, see Washington *"Corporation Executive Compensation"*, 1942, Chs. 16, 17, 19. See also the preface in Washington *"Compensating the Corporate Executive"*, 1951; Bates and Zuckert *"Directors Indemnity"; "Corporate Policy or Public Policy"*, 20 Harv. Business Rev. pp. 244-64; *"Directors' Expenses in Stockholders' Suits"*, 43 Col. L. Rev. pp. 301-16; *"Litigation Expenses of Corporate Directors in Stockholders' Suits"*, 40 Col. L. Rev. 431; 30 Calif. L. Rev. 667, 670-676; Douglas, *"Directors Who Do Not Direct"*; 47 Harv. L. Rev. 1305, 1328. See *Mooney* v. *Willis Overland Motors*, 106 F. Supp. 253, footnote at p. 257; affd. 204 F. 2d 888 (3rd Cir.) 1953. The question of whether the equity powers of bankruptcy courts may be employed to override state laws, is discussed in an article entitled *"The Erie Doctrine in Bankruptcy"* by Alfred Hill in 66 Harv. L. Rev., 1013, 1952-53.

California (Gen. Corp. L., §830); Connecticut (Gen. Stat. 1949, §5129); Delaware (Code 1953, Tit. 8, §122 (10)); District of Columbia (Business Corp. Act §4); Kentucky (Rev. Stat. 1953, §271.375); Maine (Rev. Stat. 1954, c. 53, §24); Maryland (Code 1951, Art. 23, §60); Minnesota (Rev. Stat. 1953, §301.09); Missouri (Rev. Stat. 1949, §351.355); Montana (Rev. Code 1947, §15-412); New Jersey (Rev. Stat. 914:3-14); North Carolina (Gen. Stat. §55-20); Ohio (Rev. Code 1953, c. 1701, §1701.13); Oregon (Rev. Stat. §57.030); Pennsylvania (75 Pa. Stat. §2852-410); Rhode Island (S.B. 101 L. 1948, §1); Texas (H.B.16 L. 1955, Art. 2.02); Virginia (Stock Corp. Act (L. 1956 c. 428), §13.1-3 (n)); Wisconsin (Wis. Stat. Ch. 180, §180.407).

In 1953 the American Law Institute, after more than ten years' study, published a proposed "Model Business Corporation Act", as prepared by the Committee on Corporation Laws of the American Bar Association. Section 4 of the Model Act, defining the powers of a corporation. includes, among others, the following:

> "(o) To indemnify any director or officer or former director or officer of the corporation, or any person who may have served at its request as a director or officer of another corporation in which it owns shares of capital stock or of which it is a creditor, against expenses actually and necessarily incurred by him in connection with the defense of any action, suit or proceeding in which he is made a party by reason of being or having been such director or officer, except in relation to matters as to which he shall be adjudged in such action, suit or proceeding to be liable for negligence or misconduct in the performance of duty, but such indemnification shall not be deemed exclusive of any other rights to which such director or officer may be entitled, under any by-law, agreement, vote of shareholders, or otherwise."

The decision of the Court of Appeals below, if permitted to stand as a statement of applicable federal law, could have the effect of placing a severe limitation on the state-created rights under the numerous state statutes now in effect.

Where jurisdiction of a federal district court is founded upon diversity of citizenship of the parties, it has been held by this Court that such state statutory provisions create new rights and liabilities which are not procedural but substantive and are applicable in the federal District Courts. Such was the holding in *Cohen* v. *Beneficial Loan Corporation*, 337 U. S. 541 (1948). There the question before the Court was the applicability in the federal district court of the New Jersey statute, which is substantially the same as Section 61-b of the New York statute[5] providing for security for litigation expenses. This Court upheld the constitutionality of the statute and its applicability in the federal court, saying (at pp. 555-557):

> "• • • But this statute is not merely a regulation of procedure. With it or without it the main action takes the same course. However, it creates a new liability where none existed before. • • • Such liability is not usual and it goes beyond payment of what we know as 'costs'. If all the Act did was to create this liability, it would clearly be substantive. • • • We do not think a statute which so conditions the stockholder's action can be disregarded by the federal court as a mere procedural device.
>
> • • •
>
> "We hold that the New Jersey statute applies in federal courts and that the District Court erred in declining to fix the amount of indemnity reasonably to be exacted as a condition of further prosecution of the suit."

(5) 22 McKinney's Consol. L. of N. Y. Anno., §61-b.

The liability for litigation expenses created by the state statute does not conflict with any provision of federal law, certainly not any provision of the Bankruptcy Act.

In *Stellwagen, Trustee* v. *Clum, Trustee in Bankruptcy, etc.*, 245 U. S. 605 (1918), the question was whether certain provisions of the statutes of Ohio,[6] which render void sales and conveyances designed to effect a preference of one creditor over another, were suspended by virtue of the Bankruptcy Act. There an action was commenced to require a trustee in bankruptcy to surrender and transfer a quantity of lumber and a balance due on open accounts then in possession of the trustee in bankruptcy. Answering one of the three questions certified by the Circuit Court of Appeals for the Sixth Circuit, whether the Bankruptcy Act did not operate to suspend the state statute, this Court said (at p. 613):

> "The Federal Constitution, Article I, §8, gives Congress the power to establish uniform laws on the subject of bankruptcy throughout the United States. In view of this grant of authority to the Congress it has been settled from an early date that state laws to the extent that they conflict with the laws of Congress, enacted under its constitutional authority, on the subject of bankruptcies are suspended. While this is true, state laws are thus suspended only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress. *Sturges* v. *Crowninshield*, 4 Wheat. 122; *Ogden* v. *Saunders*, 12 Wheat. 213.
>
> "Notwithstanding this requirement as to uniformity the bankruptcy acts of Congress may recognize the laws of the State in certain particulars,

(6) Ohio Rev. Stats. (1908), §§6343, 6344; 99 Ohio Laws, 241, 242.

> although such recognition may lead to different results in different States."[7]

There being no federal statute which expressly precludes the application of a state statute providing for reimbursement of litigation expenses of successful defendants in a suit brought by a federal bankruptcy trustee, there is, we submit, no conflict here which precludes the applicability of the state statute (*Hill* v. *Florida,* 325 U. S. 538 (1944)).

It appears to be the established rule that a state law will be suspended by federal law only where the federal law is so "direct and positive" that the two statutes cannot "be reconciled or consistently stand together" (*Kelly* v. *Washington,* 302 U. S. 1, p. 10 (1937); *Weber* v. *Anheuser-Busch Inc.,* 348 U. S. 468 (1955); *Garner* v. *Teamsters Union,* 346 U. S. 485 (1953); *United Auto Workers* v. *Wisconsin Employment Board,* 351 U. S. 266 (1956)).

The rule of conflict has no application, we submit, where, as here, the bankruptcy trustee, as plaintiff, is subjected to the same liability for defendants' litigation expenses for which the debtor itself would have been liable if it had brought the same plenary suit in its own right in the New York Court or even in a District Court and based the jurisdiction on the diversity of the citizenship of the parties.

In *Harrigan* v. *Bergdoll,* 270 U. S. 560, certiorari was granted to review a judgment of the Supreme Court of Pennsylvania, which affirmed a judgment for the defendant in an action brought by a trustee in bankruptcy in a state court to collect an unpaid stock subscription of the com-

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(7) Cf., §70(e) of the Bankruptcy Act (11 U.S.C., §110, 52 Stat. 879).

pany in bankruptcy. The judgment for the defendant was based on the statute of limitations. In affirming the state Supreme Court, this Court said (at pp. 564-565):

> "• • • The nature, the extent, and the conditions of the liability of a stockholder on account of stock not full-paid depend primarily upon the law of the State or country by which the corporation was created. *Glenn* v. *Liggett*, 135 U. S. 533, 548. Compare *Benedict* v. *Ratner*, 268 U. S. 353, 359 [citing lower court decisions]. That law determines whether the liability is to the corporation or is to creditors [citing lower court decisions]. Compare *Converse* v. *Hamilton*, 224 U. S. 243, 253; *Selig* v. *Hamilton*, 234 U. S. 652, 658. If the liability is to the corporation, it passes like other choses in action to the trustee in bankruptcy. The Bankrupt Law does not modify this right of action against the stockholder or create a new one. It merely provides that the right created by the state law shall pass to the trustee and be enforced by him for the benefit of creditors. The order of assessment and the direction that the trustee sue to recover were appropriate administrative proceedings in bankruptcy. See *In re Miller Electrical Maintenance Co.*, 111 Fed. 515. But it was for the court of Pennsylvania to say whether they were indispensable to the enforcement of the stockholder's liability." (8)

The analogy of the *Harrigan* case is applicable here. The bankruptcy law does not operate to modify or even to create any right of action against petitioners' assignors. The trustee in bankruptcy in the plenary suit in New York was attempting to enforce the same state-created right which the corporation itself might have at-

(8) See also *Austrian, Appellee* v. *Williams, Appellant*, 198 F. 2d, 697 (2 Cir. 1952), holding that the state statute of limitations applies to a Chapter X trustees' plenary suit in a federal district court founded on state-created rights.

tempted to enforce. Having been unsuccessful, the debtor's estate in bankruptcy is liable for the litigation expenses of the successful defendants to the same extent as the debtor itself would have been liable. Moreover, the substantive liability for litigation expenses is precisely the same if the plenary suit had been commenced by another director, ~~and~~ stockholder or by the corporation itself.

The opinion below, for its holding that the "policy" of Chapter X of the Bankruptcy Act precludes the application of the state-created liability, cited *Brown* v. *Gerdes,* 321 U. S. 178; *Leiman* v. *Gutman,* 336 U. S. 1, and *Callaghan* v. *Reconstruction Finance Corporation,* 297 U. S. 464, 468-9. The first two cases involve the jurisdiction of the reorganization court to pass upon fees for certain persons whose fees are within the scope of the express provisions of Chapter X. The jurisdiction of the reorganization court in the present proceeding is not here being questioned; and further the court below has held, on the alternative claim for relief, that the services here involved were not fees in the reorganization proceeding within the meaning of Chapter X. Petitioners do not seek review of this latter determination.

The *Callaghan* decision was apparently cited for its reference to the desire for economy in administering an estate. There the question involved ~~was~~ THE fees of the bankruptcy trustee. It is submitted that "economy" can never be a basis for cutting down the rights of persons not party to the reorganization proceedings, and whose rights arise independently of the Bankruptcy Act. The legislative policy expressed in the Bankruptcy Act is clearly indicated by 28 USC §959 (62 Stat. 926) which provides:

> **"Trustees and receivers suable; management; State laws**
>
> (a) Trustees, receivers or managers of any property, including debtors in possession, may be sued,

> without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property. Such actions shall be subject to the general equity power of such court so far as the same may be necessary to the ends of justice, but this shall not deprive a litigant of his right to trial by jury.
>
> (b) A trustee, receiver or manager appointed in any cause pending in any court of the United States, including a debtor in possession, shall manage and operate the property in his possession as such trustee, receiver or manager according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof."

While the instant situation may not fall within the express terms of that section, it is clearly analogous. The trustees, engaged in attempting to realize a "contingent asset" of the estate in New York, did so in a manner which incurred liability, to persons not party to the proceeding, under applicable state law. It is clearly not the policy of Congress to disregard such state law and the valid rights of such third parties.

The effect of the decision below, if allowed to stand, would be to strip corporate officers and directors of the protection which the state reimbursement statutes were intended to afford. Knowledge by prospective directors that they might, although blameless, be subjected to heavy and uncollectible litigation expenses in a suit by a bankruptcy trustee would create deterrence to accepting office which it was the policy of the statutes to obviate.

Such a broad nullification of the corporate policy of so many states warrants review by this Court.

POINT II

The decision below that federal substantive rights governed the New York plenary action is in direct conflict with the decisions of this Court.

In its opinion, the Court below erroneously held that the New York statute was not applicable to the plenary action in the New York District Court, citing *Fielding* v. *Allen*, 181 F. 2d 163 (2nd Cir. 1950).

The *Fielding* case involved a complaint in an action containing two counts: (1) founded upon charges of conspiracy, fraud, and breach of fiduciary duties of directors, based upon state law, and (2) founded upon an alleged violation of the Federal Transportation Act. Diversity of citizenship was alleged as to both counts. The Court of Appeals held that as to the second count, the diversity allegation was mere surplusage, and the allegations stated a federal right. Therefore, a state statute requiring security for expenses to be posted in stockholders' derivative actions was held not to control as to this count. As may be noted, however, that case involved a federally created *substantive* right.

To hold that the *Fielding* decision is applicable to the instant case is nothing less than a failure to distinguish a federal *substantive* right from a federal *jurisdictional* power, which was the only federal question involved in the plenary action against petitioners' assignors.

From the statements in the opinion, as well as from the citation of *Fielding*, it is apparent that the Court below has not differentiated the federal power which conferred jurisdiction of the trustees' plenary suit from the substantive state law on which such plenary suit was founded.

In *Williams, et al.* v. *Austrian, et al., Trustees,* 331 U. S. 642 (1946), Chief Justice Vinson, writing for the majority of this Court, held that the New York District Court had jurisdiction of the trustees' plenary suit "even though diversity or other usual ground for federal jurisdiction is lacking" (331 U. S. 642, 658). The decision of the majority was based upon the provisions of Section 2(a)(7) of the Bankruptcy Act (11 U.S.C.A. §11(a)(7)). The majority opinion further recognized, however, that as a consequence of the decision there would remain the question whether "* * * state courts will automatically be deprived of jurisdiction to hear a trustee's plenary suits" and said "But whether or not this and other suggested consequences will follow we leave for consideration in cases presenting such issue for decision" (331 U. S. 642, 662).

There can be no doubt, however, both from the majority and the dissenting opinion (Justices Frankfurter and Jackson), that the plenary action against petitioners' assignors in the New York District Court involved the question of the jurisdiction "of what is essentially State litigation" (331 U. S. at p. 667).

That this is so, was further clarified by the statements of this Court in *National Ins. Co.* v. *Tidewater Co.,* 337 U. S. 582 (1949). There the Court considered the constitutionality of an Act of Congress (Act of April 20, 1949, c. 117, 54 Stat. 143; 28 U.S.C. §1332), conferring on the federal district courts jurisdiction of civil actions involving a controversy between citizens of the District of Columbia and citizens of a state. In the opinion of the Court by Justice Jackson (in which Justices Black and Burton joined), referring to *Austrian, et al.* v. *Williams, et al., supra,* and *Schumacher* v. *Beeler,* 293 U. S. 367, it was said (at pp. 596-597):

"This assumption by the Court in the *Beeler* and *Austrian* cases, that the Congress had power to confer on the district courts jurisdiction of non-diversity suits involving only state law questions, made unnecessary any discussion of the source of the assumed power. In view of Congress' plenary control over bankruptcies, the Court may have grounded such assumption on Art. I. Or it might have considered that the jurisdiction was based on Art. III, and statutes enacted pursuant to it, giving the district courts jurisdiction over suits arising under the Constitution and laws of the United States. Had the Court held such a view, this latter might have commended itself as the most obvious answer. Consequently, silence in this respect, in the decision of each case, seems significant, particularly in contrast with repeated reference to Art. I power in the *Beeler* case, and sweeping language in the *Austrian* case that such jurisdiction existed despite lack of diversity 'or other usual ground for federal jurisdiction'. Nevertheless, it is now asserted, in retrospect, that those cases did arise under the laws of the United States. No justification is offered for that conclusion and there is no effort to say just why or how the cases did so arise. This would indeed be difficult if we still adhere to the doctrine of Mr. Justice Holmes, that 'a suit arises under the law that creates the cause of action'. *American Well Works Co.* v. *Layne Co.*, 241 U. S. 257, 260, *for the cause of action in each case rested solely on state law.*" [Italics ours.]

The opinion in the *National Ins. Co.* case also made reference to the opinion of Justice Cardozo in *Gully* v. *First National Bank*, 299 U. S. 109, holding that "To bring a case within the statute, a right to immunity created by the Constitution or laws of the United States must be an element, and an essential one, of the plain-

tiff's cause of action". There was also mentioned the opinion of Mr. Justice Stone in *Puerto Rico* v. *Russell & Co.*, 288 U. S. 476, in which he said for a unanimous court that "federal jurisdiction 'may not be invoked where the right asserted is non-federal, merely because the plaintiff's right to sue is derived from federal law, or because the property involved was obtained under federal statute. The federal nature of the right to be established is decisive—not the source of the authority to establish it'. *Puerto Rico* v. *Russell & Co.*, 288 U. S. 476, 483."

The opinion then continues (337 U. S. 582, at pp. 598-599):

> "Neither the *Austrian* nor the *Beeler* [*Schumacher* v. *Beeler*, 293 U. S. 367] case meets these tests, required before a case can be said to arise under the laws of the United States. • • • Austrian, as trustee, sued in equity for an accounting based on a charge that affairs of a state-created corporation had been conducted by the officers in violation of state law. Beeler, as trustee, sued on a contention that a levy on property by an Ohio sheriff was void under state law. Both controversies • • • called for a determination of no law question except those arising under state laws. The only way in which any law of the United States contributed to the [*Austrian*] case was in opening the district courts to the trustee, under Art. I powers of Congress • • •. The fact that the congressional power over bankruptcy granted by Art. I could open the court to the trustee does not mean that such suits arise under the laws of the United States; but it does mean that Art. I can supply a source of judicial power for their adjudication. The distinction is important and it is decisive on this issue."

In the decision after the trial of the plenary suit in the New York District Court (*Austrian* v. *Williams,* 103 F. Supp. 64 (1952), opinion by District Judge Weinfeld), it was said (at p. 111):

> "At the threshold of inquiry it would be well to define the basis of jurisdiction and the nature of this action. Federal jurisdiction in this case does not rest on diversity of citizenship—it is based on Section 2 of the Bankruptcy Act [11 U.S.C.A. §11]. The Supreme Court has held that this section established 'the jurisdiction of federal courts to hear plenary suits brought by a reorganization trustee, even though diversity or other usual ground for federal jurisdiction is lacking.' Williams *v.* Austrian, 331 U. S. 642, 658, 67 S. Ct. 1443, 1451, 91 L. Ed. 1718.
>
> "The nature of this action has been described by the Supreme Court as one 'in equity for an accounting based on a charge that affairs of a state-created corporation had been conducted by the officers in violation of state law • • •' calling 'for a determination of no law question except those arising under state laws' [citing National Mutual Ins. Co. *v.* Tidewater Transfer Co., 337 U. S. 582, 598]."

The decision below is plainly in conflict with the decision of this Court in *Williams, et al.* v. *Austrian, et al., Trustees, supra,* and the construction placed upon that decision in *National Ins. Co.* v. *Tidewater Co., supra.* It is also contrary to the holding of the New York District Court which tried and determined the New York plenary suit. For this reason alone, certiorari should be granted to review the judgment below.

POINT III

The decision of the Court of Appeals below is in conflict with the decision of the Court of Appeals for the Seventh Circuit in *In re Granada Apts.*, 155 F. 2d 882 (1946), cert. den. 329 U. S. 785 (1946).

The Court of Appeals below attempted to distinguish the decision in *In re Granada Apts., supra.* Petitioners respectfully submit that such decision of the Seventh Circuit is indistinguishable on any valid basis and that the two Courts of Appeals are, therefore, in irreconcilable conflict on the question of the applicability in federal bankruptcy court of state-created liability for litigation expenses incurred in the successful defense of a claim asserted by a Chapter X bankruptcy trustee.

In *In re Granada Apts.* a state corporation was in reorganization proceedings under Chapter X of the Bankruptcy Act. A trustee under a mortgage indenture made claim in the reorganization court for its expenses and charges incurred in a foreclosure suit in the state court prior to the reorganization proceeding. The bankruptcy reorganization trustee interposed a counterclaim against the indenture trustee for surcharge for alleged wrongful conduct in the management of the mortgaged properties prior to the filing of the reorganization petition.

The issue was tried in the reorganization court as a plenary action. In the reorganization court the bankruptcy trustee won a judgment. On appeal the judgment was reversed on the ground that the district court's findings of liability of the mortgage trustee were not supported by the evidence (155 F. 2d 882, 886).

Subsequently, the mortgage trustee filed in the reorganization court a petition for reimbursement of its reason-

able expenses, including attorneys' fees, incurred in the successful defense of the surcharge suit of the reorganization trustee. The district court, as the bankruptcy reorganization court, denied the petition. The Court of Appeals described the petition as "addressed to the court as a court of equity, and was not drawn under any provision of the bankruptcy law" (p. 887). On the indenture trustee's appeal from such denial, the Court of Appeals for the Seventh Circuit, apparently relying on Illinois common law, said (155 F. 2d at p. 888):

> "* * * In defending against the counterclaim, claimant was not engaged in maintaining its claim 9, nor the fee petitions of the Bondholders' Committee and its counsel. It was merely engaged in defending itself against a plenary action for damages, and under the well-recognized general rule, it was entitled to reimbursement of its expense so incurred."

The Court of Appeals referred to a Special Master's finding that attorney's fees of $15,000 and out-of-pocket expenses, except an item of $1,135.30 incurred by the indenture trustee in the defense of the plenary action, were proper and should be allowed, saying (at p. 888):

> "* * * Under broad equitable principles those findings are certainly sound. Patterson *v.* Northern Trust Co., 286 Ill. 564, 122 N. E. 55; Waterman *v.* Alden, 144 Ill. 90, 32 N. E. 972; Scott on Trusts, Vol. 2, sec. 188.4; Perry on Trusts (7th Ed.), sec. 894; Bogert on Trusts, Vol. 4, §805."

The authorities cited support the right of a trustee to reimbursement of his litigation expenses.

The Court further held that it was not necessary that the indenture trustee show a benefit to the debtor's estate and distinguished *Woods* v. *City National Bank & Trust*

Co., 312 U. S. 262, on the ground that the *Woods* case was not applicable to the type of claim here involved, stating (at pp. 887, 888):

> "* * * It [the *Woods* case] does not expressly say so, nor was the Court there dealing with this kind of a claim. It was there dealing with claims alleged to be beneficial to the estate, and the Court merely held that claims for out-of-pocket expense in such cases must be proved to be beneficial to the estate. Here, the counterclaim was directed against claimant, not against the debtor or the Bondholders' Committee, for the Court Trustee was prosecuting the case for their benefit. Under such circumstances claimant had a right to defend its liability and its honor. It did so successfully and nothing was recovered on the cross complaint * * *."

The Court of Appeals below said of *Granada* (opinion, p. 17):

> "* * * Under the indenture it [the indenture trustee] had the contractual right to deduct from the property or funds in its possession such [litigation] expenses. The holding in the case was, therefore, not inconsistent with the specific provisions of Chapter 10 but illustrates only the well established equity doctrine that a trustee in possession is entitled to be allowed from the fund in his possession expenses incurred in defending the trust committed to its charge, including reasonable compensation for services and expenses."

The facts stated in the Court's opinion in *Granada* clearly show that both at the time the litigation expenses were incurred and at the time reimbursement was sought, the indenture trustee was not a "trustee in possession", the possession of the property having then been taken over by the bankruptcy reorganization trustee. While under

"well established equity doctrine" it is doubtless true that an indenture trustee is entitled to reimbursement for its litigation expenses in defending successfully against surcharge proceedings, it is clear from the opinion of the Seventh Circuit Court that such "doctrine" has its basis in state law, since only decisions of Illinois courts were cited. The allowances of the indenture trustee's litigation expenses were allowed as provided in the common law of Illinois.

The instant case also involves claims for litigation expenses of corporate fiduciaries, *i.e.*, former directors of the debtor corporation, to whom the New York statutes have extended the same substantive right to reimbursement heretofore granted by common law rules to other types of fiduciaries—the right to be reimbursed from the corporate properties and assets entrusted to the directors' management and control for expenses incurred in defending successfully against charges of misfeasance in the management of the corporation's business. That this protection is provided by comparatively recent statutory enactments does not make it any less "well established". As in *Granada,* it would not be inconsistent with the provisions of Chapter X of the Bankruptcy Act to allow the litigation expenses of petitioners' assignors, as provided in the New York statute.

Conclusion

For the reasons stated, petitioners respectfully pray that a writ of certiorari issue to review the decision below.

Respectfully submitted,

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APPENDIX

The Statutes

Pertinent Provisions of Article 6—General Corporation Law of New York

JUDICIAL SUPERVISION OF CORPORATION AND OF THE OFFICERS AND MEMBERS THEREOF

"§60.[1] *Action against directors or officers of corporation for misconduct.*—An action may be brought against one or more of the directors or officers of a corporation to procure judgment for the following relief or any part thereof:

"1. To compel the defendants to account for their official conduct, including any neglect of or failure to perform their duties, in the management and disposition of the funds and property, committed to their charge.

"2. To compel them to pay to the corporation, or to its creditors, any money and the value of any property, which they have acquired to themselves, or transferred to others, or lost, or wasted, by or through any neglect of or failure to perform or other violation of their duties.

"3. To suspend a defendant from exercising his office, for an abuse of his trust.

"4. To remove a defendant from office and to direct the filling of the vacancy in accordance with the charter and by-laws of the corporation, or, if they contain no provision therefor, in such manner as the court shall direct.

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(1) L. 1929 c. 650 §1, as amended L. 1944 c. 727 §1.

"5. To set aside a transfer of property, made by one or more directors or officers of a corporation, contrary to a provision of law, where the transferee knew the purpose of the transfer.

"6. To enjoin such a transfer where there is good reason to apprehend that it will be made."

* * * * *

"§61.[2] *Who may bring such action.*—An action may be brought for the relief prescribed in section sixty of this chapter, by * * * the corporation or a creditor, receiver or trustee in bankruptcy thereof, or by a director or officer of the corporation."

* * * * *

Pertinent Provisions of Article 6-A of The General Corporation Law of New York[3]

Reimbursement of Litigation Expenses of Corporate Officials

"§64. *Assessment of expenses.*—Any person made a party to any action, suit or proceeding by reason of the fact that he, his testator or intestate, is or was a director, officer or employee of a corporation shall be entitled to have his reasonable expenses, including attorneys' fees, actually and necessarily incurred by him in connection with the defense of such action, suit or proceeding, and in connection with any appeal therein, assessed against the corporation or against another corporation at the request of which he served as such director, officer or employee, upon court order, in the manner and to the extent provided by sections sixty-five, sixty-six and sixty-

(2) L. 1946 c. 162 §1.
(3) L. 1945 c. 869 §4.

seven of this chapter, and in the instances specified in section sixty-eight of this chapter, except in relation to matters as to which it shall be adjudged in such action, suit or proceeding that such officer, director or employee is liable for negligence or misconduct in the performance of his duties."

"§65. *Application for payment or assessment of expenses.*—Application for payment of expenses under the provisions of a certificate of incorporation, or other certificate filed pursuant to law, by-law or resolution, or for assessment of expenses pursuant to section sixty-four of this chapter, may be made either (a) in the action, suit or proceeding brought in this state in which such expenses were incurred, or (b) to the supreme court in a separate proceeding. Such application shall show the disposition of any previous application made to any court. If not made in the action, suit or proceeding in which the expenses were incurred, such application shall also show reasonable cause for failure to make application in such action, suit or proceeding."

"§66. *Manner and form of application; notice.*—An application pursuant to section sixty-five of this chapter shall be made in such manner and form as may be required by applicable rules of court or in the absence thereof by direction of the court to which it is made. Such application shall be upon notice to the corporation. The court may also direct that notice be given at the expense of the corporation to such other persons as it may designate in such manner as it may require."

"§67. *When award to be made.*—If after hearing an application for payment or for assessment of expenses, the court shall find that the applicant, his testator or

intestate was successful in whole or in part, or that the action against him has been settled with the approval of the court, the court shall grant such application in such amount as it shall find to be reasonable, and shall make an order directing the corporation to pay to the applicant the amount awarded; provided, however, that no award of indemnity or assessment of expenses shall be made in any case where it shall appear (i) that the law of the state of incorporation of the corporation prohibits such indemnity or assessment, or (ii) that the award would be inconsistent with any action of the stockholders or members of the corporation taken prior to and in effect at the time of the accrual of the alleged cause of action; or (iii) if there has been a settlement approved by the court, that the award would be inconsistent with any condition with respect to payment of indemnity or assessment of expenses expressly imposed by the court in approving such settlement."

"§68. *When and by whom application may be made.*— Sections sixty-four, sixty-five, sixty-six and sixty-seven of this chapter shall apply to an application made to a court in this state in any of the following cases:

"(a) when the corporation against whom the application is made for assessment of expenses pursuant to section sixty-four or for payment of expenses under the provisions of a certificate of incorporation, or other certificate filed pursuant to law, by-law or resolution, is a domestic corporation or a corporation doing business in this state;

"(b) when such expenses were incurred in an action or proceeding maintained in a court in this state;

"(c) when the application is made by a resident of this state and the director, officer or employee was a resident of this state at the time of the accrual of the alleged cause of action asserted in the litigation in which such expenses were incurred."

Pertinent Provisions of the Bankruptcy Act

CHAPTER II

Section 2.[4] Creation of Courts of Bankruptcy and Their Jurisdiction.

a. The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—

(2) Allow claims, disallow claims, reconsider allowed or disallowed claims, and allow or disallow them against bankrupt estates;

(7) Cause the estates of bankrupts to be collected, reduced to money, and distributed, and determine controversies in relation thereto, except as herein otherwise provided, * * *; and where in a controversy arising in a proceeding under this Act an adverse party does not interpose objection to the summary jurisdiction of the

(4) 11 U.S.C., sec. 11, 30 Stat. 545 as amended 52 Stat. 842, 66 Stat. 420.

court of bankruptcy, by answer or motion filed before the expiration of the time prescribed by law or rule of court or fixed or extended by order of court for the filing of an answer to the petition, motion or other pleading to which he is adverse, he shall be deemed to have consented to such jurisdiction;

(15) Make such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this Act: *Provided, however,* That an injunction to restrain a court may be issued by the judge only;

(18) Tax costs and render judgments therefor against the unsuccessful party, against the successful party for cause, in part against each of the parties, and against estates, in proceedings under this Act;

• • •

b. Nothing in this section contained shall be construed to deprive a court of bankruptcy of any power it would possess were certain specific powers not herein enumerated.

CHAPTER X

Sec. 102.[5]—The provisions of chapters I to VII, inclusive, of this Act shall, insofar as they are not inconsistent or in conflict with the provisions of this chapter, apply in proceedings under this chapter: *Provided, however,* That section 23, subdivisions h and n of section 57, section 64, and subdivision f of section 70, shall not apply in such proceedings unless an order shall be entered directing that bankruptcy be proceeded with pursuant to the provi-

(5) 11 U.S.C., sec. 502, 52 Stat. 883.

sions of chapters I to VII, inclusive. For the purposes of such application, provisions relating to "bankrupts" shall be deemed to relate also to "debtors", and "bankruptcy proceedings" or "proceedings in bankruptcy" shall be deemed to include proceedings under this chapter. For the purposes of such application the date of the filing of the petition in bankruptcy shall be taken to be the date of the filing of an original petition under section 128 of this Act, and the date of adjudication shall be taken to be the date of approval of a petition filed under section 127 or 128 of this Act except where an adjudication had previously been entered.

Sec. 111.[6] Where not inconsistent with the provisions of this chapter, the court in which a petition is filed shall, for the purposes of this chapter, have exclusive jurisdiction of the debtor and its property, wherever located.

Sec. 221.[7] The judge shall confirm a plan if satisfied that—

(1) the provisions of article VII, section 199, and article X of this chapter have been complied with;

(2) the plan is fair and equitable, and feasible;

(3) the proposal of the plan and its acceptance are in good faith and have not been made or procured by means or promises forbidden by this Act;

(4) all payments made or promised by the debtor or by a corporation issuing securities or acquiring property under the plan or by any other person, for services and for costs and expenses in, or in connection with, the pro-

(6) 11 U.S.C., sec. 511, 52 Stat. 884.
(7) 11 U.S.C., sec. 621, 52 Stat. 897.

ceeding or in connection with the plan and incident to the reorganization, have been fully disclosed to the judge and are reasonable or, if to be fixed after confirmation of the plan, will be subject to the approval of the judge; and

(5) the identity, qualifications, and affiliations of the persons who are to be directors or officers, or voting trustees, if any, upon the consummation of the plan, have been fully disclosed, and that the appointment of such persons to such offices, or their continuance therein, is equitable, compatible with the interests of the creditors and stockholders and consistent with public policy.

Sec. 241.[8] The judge may allow reimbursement for proper costs and expenses incurred by the petitioning creditors and reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred in a proceeding under this chapter—

(1) by a referee;

(2) by a special master;

(3) by the trustee and other officers, and the attorneys for any of them;

(4) by the attorney for the debtor; and

(5) by the attorney for the petitioning creditors.

Such compensation of referees and trustees shall not be governed by sections 40 and 48 of this Act.

Sec. 242.[9] The judge may allow reasonable compensation for services rendered and reimbursement for proper

(8) 11 U.S.C., sec. 641, 52 Stat. 900.
(9) 11 U.S.C., sec. 642, 52 Stat. 900.

costs and expenses incurred in connection with the administration of an estate in a proceeding under this chapter or in connection with a plan approved by the judge, whether or not accepted by creditors and stockholders or finally confirmed by the judge—

(1) by indenture trustees, depositaries, reorganization managers, and committees or representatives of creditors or stockholders;

(2) by any other parties in interest except the Securities and Exchange Commission; and

(3) by the attorneys or agents for any of the foregoing except the Securities and Exchange Commission.

Sec. 243.[10] The judge may allow reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred by creditors and stockholders, and the attorneys for any of them, in connection with the submission by them of suggestions for a plan or of proposals in the form of plans, or in connection with objections by them to the confirmation of a plan, or in connection with the administration of the estate. In fixing any such allowances, the judge shall give consideration only to the services which contributed to the plan confirmed or to the refusal of confirmation of a plan, or which were beneficial in the administration of the estate, and to the proper costs and expenses incidental thereto.

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(10) 11 U.S.C., sec. 643, 52 Stat. 900.

APPENDIX

Opinion of United States Court of Appeals, Fourth Circuit

(Before PARKER, Chief Judge, SOPER, Circuit Judge, and CHESNUT, District Judge)

CHESNUT, District Judge,

In 1942 the Central States Electric Corporation, a Virginia corporation, filed a petition in the United States District Court for the Eastern District of Virginia, for reorganization under the provisions of Chapter 10 of the Bankruptcy Act (11 USCA, ss, 501 et seq). The District Judge approved the petition and assumed jurisdiction and appointed Trustees. Later in 1944 in the course of administration the court made an order authorizing the Trustees to institute suit against certain officers and directors, and Harrison Williams, the majority stockholder of the corporation, for an accounting and recovery of damages for alleged breach of their duties to the corporation. In 1945 the Trustees filed the suit in the District Court of the United States for the Southern District of New York. Freeman and Fogarty were two of the directors so sued. After long litigation, in 1952 the suit against them finally failed on account of limitations. In December 1955 the appellants in this case, Randall J. LeBoeuf, Jr., Horace R. Lamb and others, who had acted as counsel for Freeman and Fogarty, filed a petition in the bankruptcy court, as assignees of Freeman and Fogarty and individually in their own right as counsel, for the allowance of fees and expenses in the amount of $31,185.53. After hearing, the District Judge dismissed the petition and this appeal has resulted.

Appendix

At the outset, we note the contention of the appellee, the present Trustee, that the appeal was not taken as a matter of right but only if allowed in its discretion by this court, as provided in section 250 of Chapter 10 of the Bankruptcy Act (11 USCA, s. 650) as construed by the Supreme Court in *Dickinson* v. *Cowan*, 309 U.S. 382 (1940). The appellants contend, however, that as their petition was dismissed and involved a claim asserted by them under a New York statute, the appeal is a matter of right and not merely discretionary. We find it unnecessary to resolve this conflict because, to the extent that the appeal is only discretionary, we think it should be allowed. Accordingly we allow the appeal and proceed to the consideration of its merits.

The order of the Reorganization Court which authorized the suit by the Trustees resulted only after litigation and was succeeded by long protracted litigation. A brief summary of all this will furnish the background for the question presented on the present appeal.

The Trustees originally appointed, after conducting an investigation under section 167 of Chapter 10 (11 USCA, s. 567) reported to the Judge that the investigation indicated misconduct and mismanagement by officers and directors of the corporation but recommended against the institution of suits by reason of anticipated expense to be incurred and possible or probable successful defense based on limitations. The Judge approved the report and accordingly then declined to authorize the suit; but a number of interested security holders appealed the order which was reversed by the Court of Appeals for the Fourth Circuit, *Committee* v. *Kent, et al*, 143 F. 2d. 684 (1944). In the opinion it was noted that between

1929 and 1943 the assets of the corporation had decreased from the sum of $350,000,000 to about $11,000,000. Shortly thereafter the Trustees originally appointed, retired, new Trustees were appointed and, after further investigation recommended that suit be brought and the Judge authorized institution of suit against the officers and directors and Harrison Williams, the majority stockholder of the corporation.

In 1945 the new Trustees filed a suit in equity for an accounting and damages against the directors, Freeman and Fogarty, Williams and others. The suit was evidently instituted in the United States District Court for the Southern District of New York where personal service could be obtained upon the defendants. The complaint did not allege diversity of citizenship but was a suit on equitable principles for an accounting and damages authorized by the Bankruptcy Act, thus presenting a federal question as the basis for jurisdiction in the federal court in New York. The defendants moved to dismiss the case for lack of jurisdiction and the District Judge so ordered. *Austrian, et al,* v. *Williams, et al,* 67 F. Supp. 223. But on appeal the order was reversed by the Court of Appeals for the Second Circuit, *Austrian, et al,* v. *Williams, et al,* 159 F. 2d. 67, and the case was remanded to the District Court for further proceedings. This order of the Second Circuit was affirmed by the Supreme Court in *Williams, et al,* v. *Austrian, et al, Trustees,* 331 U.S. 642.

On the remand the District Court after a lengthy trial, determined with respect to Freeman and Fogarty that the evidence did not sustain the charges of misconduct against them in a number of separate instances alleged, but did

with respect to three others, and that a decree against Freeman in the amount of $593,693.44, plus interest and against Fogarty in the amount of $748,122.24 plus interest, would be justified except for their plea of the statute of limitations which the District Judge found was a legal bar to their liability as they had retired as directors of the corporation more than ten years prior to the institution of the suit. *Austrian, et al,* v. *Williams, et al,* 103 F. Supp. 64, at pages 92, 96, 97, and 101. In his opinion the District Judge found a much larger liability against the defendant, Williams, and held that as to him the defense of the statute of limitations was not good because, in his opinion, the alleged misconduct was not discovered until shortly before the institution of the suit. Freeman and Fogarty did not appeal this decision, nor did the Trustees. But on appeal taken by Williams, the decrees of the District Court were reversed on the ground that the case against Williams was barred by the ten-year period of the New York statute of limitations and that there was error on the part of the District Judge in holding that the statute did not begin to run against Williams until the discovery of the misconduct because the judicial decisions of the State of New York regarding the ten-year statute of limitations were inconsistent with the tolling of the statute until the discovery of the misconduct. *Austrian, et al,* v. *Williams, et al,* 198 F. 2d. 697 (2nd. Cir.). The Trustees' petition for certiorari was denied by the Supreme Court, 344 U.S. 909 (Dec. 1952).

The suit against Freeman and Fogarty having been finally ended, they applied to the District Judge in New York for an allowance for expenses in their successful defense of the suit against them, basing their application on the

provisions of ss. 63-68 of Art. 6-A of the General Corporation Law of New York. It appears that they have paid $25,000 counsel fees. The Trustees opposed the application but after hearing, the District Judge made an order allowing the petitioners the sum of $31,185.53, but providing that the enforcement of the order should be made only by the Reorganization Court in Virginia. The Trustees appealed from this order to the Second Circuit, where it was reversed in an opinion by Judge Harlan (now Justice Harlan of the Supreme Court), on the ground that such an application must be made to and determined only by the Reorganization Court in Virginia. *Austrian, et al,* v. *Williams, et al,* 216 F.2d 278 (1954), cert. den. 348 U.S. 953. The reversal was without prejudice to the right of the petitioners to present their application to the Reorganization Court in Virginia. Accordingly in December 1955, application was so made to the Virginia Court and was opposed by the Trustees and the Securities and Exchange Commission, and, after hearing, District Judge Hutcheson dismissed the petition with a short opinion in which he held that authority, if any, to grant the allowance must be found in the provisions of Chapter 10 and could not be based upon Article 6-A of the New York corporation law; and that the allowance was not authorized by the provisions of Chapter 10 because the services for which compensation was asked were not of benefit to the assets of the corporation and made no contribution to the reorganization itself. It may also be noted that during the long period of more than ten years since the filing of the petition in 1942 by reason of economic and other conditions not necessary to be here noted, the assets of the corporation have increased to about $38,000,000, but still were insufficient to fully satisfy pre-

ferred stockholders or provide for the common stock. And in the meantime the plan of reorganization has been approved by the District Court and by the Fourth Circuit Court of Appeals and has been consummated. See *In re Central States Electric Corp.* 112 F. Supp. 281; *Central States* v. *Austrian,* 183 F.2d. 879; *Chase* v. *Austrian,* 189 F. 2d. 555.

Coming now to consideration of the particular point presented by the instant appeal, we find that the primary and most stressed contention of the appellants is that it was entitled to have the allowance made under the provisions of the New York statute above referred to which they contend created a substantive State right applicable to and controlling in the Reorganization Court. In the alternative they also contend that if this is not so, then in any event the allowance should have been granted by the District Judge under the principles of equity prevailing in bankruptcy and would be justified by certain specified sections of Chapter 10, which we will later consider in more detail.

In support of their primary contention appellants rely principally upon the opinion of the New York District Judge in making the allowance to them. *Austrian, et al,* v. *Williams, et al.* 120 F.Supp 900. In that case the District Judge held that the New York statute created a substantive State right which was enforceable in bankruptcy and that as it was mandatory in its terms as he construed it, he felt obliged to make the allowance even though he intimated that if the matter had been discretionary he might not have done so in view of his finding of facts to the effect that the defendants would have been held liable in very large sums except for their successful defense based on the statute of limitations. The New York statute is to be found in Arti-

cle 6-A of the New York General Corporation Law, sections 60-68. Section 60 authorizes an action against directors and officers of a corporation to compel them to account for official misconduct and to pay damages therefor. Section 61 provides that such an action may be brought by the Attorney General or by a creditor, receiver or trustee in bankruptcy. Section 64 provides that a director so sued "shall be entitled to have his reasonable expenses, including attorneys' fees * * * assessed against the corporation * * * upon court order * * * except in relation to matters as to which it shall be adjudged in such action, suit or proceeding that such officer, director or employee is liable for negligence or misconduct in the performance of his duties." Section 67 provides that "if * * * the court shall find that the applicant * * * was successful in whole or in part * * * the court shall grant such application in such amount as it shall find to be reasonable, and shall make an order directing the corporation to pay to the applicant the amount awarded; provided, however, that no award of indemnity or assessment of expenses shall be made in any case where it shall appear (1) that the law of the State of incorporation of the corporation prohibits such indemnity or assessment, or * * *." Section 68 provides that sections 64 and 67 shall apply to an application "made to a court in this State in any of the following cases: (a) when the corporation against whom the application is made * * * is a domestic corporation or a corporation doing business in this state; (b) when such expenses were incurred in an action or proceeding maintained in a court in this State; (c) when the application is made by a resident of this State and the director, officer or resident of this State and the primary officer or employee was a resident of this State at the time of the

accrual of the alleged causes of action asserted in the litigation in which such expenses were incurred."

While the phraseology used in these sections of the New York General Corporation Law seem to have relation particularly to actions in the State Courts of New York, we may assume that they would be applicable also to suits in the federal court in New York if the jurisdiction were based solely on diversity of citizenship. See *Cohen, Executrix, et al,* v. *Beneficial Industrial Loan Corporation,* 337 U.S. 541. But it is importantly to be noted that the action brought against the directors in the federal court in New York was not based on diversity of citizenship at all but was an action based on the general principles of jurisprudence and it was finally established by long litigation that the jurisdiction of the District Court in New York was controlled by federal law and not by diversity of citizenship. Furthermore the substantive right of action was in no way based on the authority of the particular New York statute which indeed in its fundamental aspects is merely a reflection but not a creation of the substantive equitable rights contained in equity jurisprudence.

In the opinion of the District Judge in the New York case it appears that his principal reason for holding that this New York statute was applicable to and controlling in the matter of the application by petitioners flowed from his interpretation of the reasoning of the Second Circuit in the case of *Austrian, et al,* v. *Williams, et al,* 198 F.2d. 697, in which the Court of Appeals reversed the decree of the District Court holding that Williams, one of the defendants, was not saved by the statute of limitations; but that the statute was applicable and a bar to the action against him by reason of the separate ten-year

New York statute of limitations as applied in the judicial decisions of the New York Court. The reasoning of the District Judge in the matter of the subsequent application for allowance of expenses was to the effect that as the Court of Appeals had applied the New York statute of limitations in upholding the defense of limitations, he felt that by the same reasoning the other New York statute, that is sections 60-68 of the General Corporation Law of the State of New York, must also be applied in the matter of the application for expenses. However, it appears that the holding of the Court of Appeals was based on a particular limitation statute in the Bankruptcy Act, that is section 11(e) of the original Bankruptcy Act as added in 1938, 11 USCA, s.29). Section 11 (e) now provides:

"S.29. Suits by and against bankrupts

• • •

(e) A receiver or trustee may, within two years subsequent to the date of adjudication or within such further period of time as the Federal or State law may permit, institute proceedings in behalf of the estate on any claim against which the period of limitation fixed by Federal or State law had not expired at the time of the filing of the petition in bankruptcy. • • •"

And this was made even plainer in the opinion of the Second Circuit by Circuit Judge (now Justice) Harlan, reversing the allowance made by the District Judge. *Austrian, et al,* v. *Williams, et al,* 216 F.2d. 278; cert. den. 348 U.S. 953. On the question now under discussion it is important to note that the New York ten-year statute of limitations is an entirely separate statute from Article 6-A of the New York General Corporation Law. The reason that

the New York limitation statute was applied was based on section 11(e) of the Bankruptcy Act which provided that the action might be brought within the time allowed by any applicable federal or *State* law; and the reason for applying the State law of New York as to limitations was because it was the law of the forum which was made applicable by the doctrine of the conflict of laws as the Central States was a Virginia corporation.

The appellants now strongly contend that apart from the reasons given in the opinion of the New York District Judge who made the allowance under the New York statute, and the opinion of the Second Circuit which reversed the order, that the New York statute is controlling in the case because it creates a substantive State right which is not contrary to but consistent with Chapter 10. The chief support for this contention is thought to be found in *Cohen, Administratix,* v. *Beneficial Industrial Loan Corporation,* 337 U.S. 541. But that was a diversity case where, under the principle of *Erie RR* v. *Tompkins,* 304 U.S. 64, the State law was obligatory; while in the present case the jurisdiction of the New York District Court was not founded on the diversity jurisdiction but on federal bankruptcy law. This distinction is well illustrated in *Fielding, et al,* v. *Allen, et al,* 181 F.2d. 163 (2nd. Cir. 1950) (cert. den. 340 U.S. 817), where, in a stockholders derivative suit it was held that to the extent the case was based on federal law and not diversity, this New York statute was not applicable.

We cannot agree with the appellants' contention. The New York litigation stemmed from an order of the Reorganization Court to institute the action. As previously noted, the sole reason for bringing the action in New York was due to the accidental fact that the defendants could

there be personally served. The Bankruptcy Act is intended to be uniform throughout the States except to the extent that its own provisions are to the contrary, as, for instance, where local State property rights are involved. We think it contrary to the manifest policy of Chapter 10 to subject and hamper its provisions by a State statute which would authorize awarding fees and expenses to defendants sued for recovery of assets of the corporation whether the suits are successful or not. Of course such suits not based on probable cause should not be authorized by the Reorganization Judge and cannot be instituted without his order of approval. But section 167 of Chapter 10 (11 USCA, s. 567) imposes the duties on the reorganization trustee to investigate and report to the Judge any facts pertaining to misconduct or mismanagement in any cause of action available to the estate. Even more importantly, it was the purpose of Chapter 10 to preserve and conserve the estate for the benefit of creditors and stockholders and to that end to reasonably minimize the expenses of administration. More particularly, as later pointed out, Chapter 10 contains several specific provisions with respect to what allowances for services and expenses may be made and to whom they may be made. As the determination of such allowance is committed entirely to the judgment of the Reorganization Court, it would be quite inconsistent with this important policy of Chapter 10 to subject the judicial discretion of the Reorganization Judge to the absolute requirements of a particular State statute which could not possibly come into play except for the accidental fact that the defendants sued were subject to personal service only within the particular federal district which, in this case, was the Southern District of New York. As to the manifest object and policy of Chapter 10 see *Brown, et al,* v. *Gerdes, et al,* 321 U.S.

178; *Leiman, et al,* v. *Guttman, et al,* 336 U. S. 1; *Callaghan* v. *Reconstruction Finance Corporation,* 297 U.S. 464, 468-9.

We therefore hold in agreement with the Reorganization Judge that the New York statute now so strongly relied upon by the appellants is not controlling with respect to the appellants' petition for allowance. On the contrary we hold that whether the allowances can or should be made must depend upon the particular provisions of Chapter 10 applicable to the case.

The sections relied upon by the appellants, and we think the only ones that need be considered, are sections 221(4), 241(3), 242 and 243 of Chapter 10 (11 USCA,ss. 621(4), 641 (3), 642 and 643). They will be found set out at length in the margin.[1]

1: "S. 621. Confirmation by court

The Judge shall confirm a plan if satisfied that—

(1) the provisions of subchapter VII, section 599, and subchapter X of this chapter have been complied with;

(2) the plan is fair and equitable, and feasible;

(3) the proposal of the plan and its acceptance are in good faith and have not been made or procured by means or promises forbidden by this title;

(4) all payments made or promised by the debtor or by a corporation issuing securities or acquiring property under the plan or by any other person, for services and for costs and expenses in, or in connection with, the proceeding or in connection with the plan and incident to the re-organization, have been fully disclosed to the judge and are reasonable or, if to be fixed after confirmation of the plan, will be subject to the approval of the judge; and

(5) the identity, qualifications, and affiliations of the persons who are to be directors or officers, or voting trustees, if any, upon the consummation of the plan, have been fully disclosed, and that the appointment of such persons to such offices, or their continuance therein, is equitable, compatible with the interests of the creditors and stockholders and consistent with public policy."

"S.641. Petitioning creditors; court officers; attorneys therefor

The Judge may allow reimbursement for proper costs and expenses incurred by the petitioning creditors and reasonable compensation for

Appendix

Section 221 states the conditions requisite for confirmation of a reorganization plan. Among them, in subsection (4), is the requirement that all payments made or promised by the debtor incident to the reorganization have been fully disclosed to the Judge and are reasonable or,

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services rendered and reimbursement for proper costs and expenses incurred in a proceeding under this chapter—

(1) by a referee;

(2) by a special master;

(3) by the trustee and other officers, and the attorneys for any of them;

(4) by the attorney for the debtor; and

(5) by the attorney for the petitioning creditors.

Such compensation of referees and trustees shall not be governed by sections 68 and 76 of this title."

"S.642. Representatives and other parties in interest; attorneys therefor

The judge may allow reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred in connection with the administration of an estate in a proceeding under this chapter or in connection with a plan approved by the judge, whether or not accepted by creditors and stockholders or finally confirmed by the judge—

(1) by indenture trustees, depositaries, reorganization managers, and committees or representatives of creditors or stockholders;

(2) by any other parties in interest except the Securities and Exchange Commission; and

(3) by the attorneys or agents for any of the foregoing except the Securities and Exchange Commission."

"S.643. Creditors and stockholders; attorneys therefor

The judge may allow reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred by creditors and stockholders, and the attorneys for any of them, in connection with the submission by them of suggestions for a plan or of proposals in the form of plans, or in connection with objections by them to the confirmation of a plan, or in connection with the administration of the estate. In fixing any such allowances, the judge shall give consideration only to the services which contributed to the plan confirmed or to the refusal of confirmation of a plan, or which were beneficial in the administration of the estate, and to the proper costs and expenses incidental thereto."

if to be later fixed, will be subject to his approval. It does not appear that the reorganization plan in this case made any promise or provision for the compensation now asked by the appellants.

Section 241 provides that the Judge may allow reimbursement and reasonable compensation for services rendered and reimbursement for costs and expenses incurred by a referee, a special master, the trustee and other officers and attorneys or any of them; by the attorneys for the debtor and the attorneys for the petitioning creditors. Clearly this section does not authorize the allowance now asked.

Section 242 also authorizes the Judge to allow reasonable compensation for services and reimbursement for proper costs and expenses in connection with the plan, by indenture trustees, depositaries, reorganization managers and committees, or representatives of creditors or stockholders, and "by any other parties in interest except the Securities and Exchange Commission and (3) by the attorneys or agents of any of the foregoing." We think it cannot be said that Freeman and Fogarty were parties in interest in connection with the plan or reorganization. Their only interests were adverse to the estate.

Section 243 further provides for compensation and reimbursement to creditors and stockholders and the attorneys for any of them in connection with the judicial consideration of the plan, whether for or against it, or in connection with the administration of the estate; but adds that "in fixing any such allowances the Judge shall give consideration only to the services which contributed to the plan confirmed or to the refusal of confirmation of a plan, or

which were beneficial in the administration of the estate, and to the proper costs and expenses incidental thereto." Of course the appellants were neither creditors nor stockholders nor attorneys for creditors or stockholders, and therefore this section furnishes no authority for the allowance requested.

We do not find that these several sections, considered either singly or collectively, give authority for the allowances here requested. It is to be borne in mind that the main purpose of Chapter 10 is to rehabilitate a financially distressed corporation; and to accomplish this it is obviously important, if not necessary, to conserve its assets and so far as reasonably possible to minimize the expenses of reorganization. The long litigation which has previously occurred here and the compensation now requested for services and expenses resulted from an effort based on probable grounds to recover assets for the corporation, or damages for loss of such assets. The recovery failed by reason only of the successful defense of limitations, as to a very large amount of damages sought. The litigation was throughout a purely adversary one. Freeman and Fogarty had no interest either in opposition to or in the success of the reorganization plan. They were not parties in interest in connection with the reorganization.

We may also take notice of the well known fact that since the enactment of 77B of the Bankruptcy Act and shortly thereafter the enactment of Chapter 10, there have been numerous judicial proceedings for reorganization of distressed corporations, in practically all of which there have been requests for allowances for services by parties in interest, or their attorneys; but we cannot recall any instance, nor has any been called to our attention, where an allowance has been made to persons or their attorneys not

interested in or contributing in any way to the plan but holding only interests adverse to the assets of the corporation, and whose services have in no way been beneficial in working out the plan for reorganization, as in this case.

In the one reported case that we have noted, similar to the present, the court refused to make an allowance of expenses, under section 77B, to directors who had been sued in New York for alleged dereliction of duties. In the *Matter of Pressed Steel Car Co. of New Jersey, Debtor,* 33 Am. B. R. (N.S.) 296, 305, (W. D. Pa. 1937).

In the appellants' reply brief reliance is based on *In re Granada Apartments, Inc.-City Nat. Bank & Trust Co. of Chicago* v. *Granada Apartments Hotel Corp.* (7th Cir. 1946) 155 F.2d.882, which the appellants think supports their contention that the District Judge should have made the allowance to them. But we find the case clearly distinguishable. In that case the Granada Apartments was in reorganization. A substantial part of its assets was held by an Indenture Trustee under mortgage for security of bonds issued. The Indenture Trustee had foreclosed the property in the State Court in Illinois and had been given a decree for the debt secured and in addition, fees to the Trustee and its attorneys. The Indenture Trustee filed a claim in the bankruptcy case for these amounts. The Reorganization Trustee, however, challenged the claim and filed a petition undertaking to surcharge the Indenture Trustee on various grounds. The controversy was not heard summarily but by a plenary proceeding. The Indenture Trustee prevailed against the attempted surcharge. It made claim for its reasonable expenses for successfully defending itself with respect to its duties as Indenture Trustee. Under the indenture it had the

contractual right to deduct from the property or funds in its possession such expenses. The holding in the case was, therefore, not inconsistent with the specific provisions of Chapter 10 but illustrates only the well established equity doctrine that a trustee in possession is entitled to be allowed from the fund in his possession expenses incurred in defending the trust committed to its charge, including reasonable compensation for services and expenses. See also *Woods* v. *City Bank Co.*, 312 U.S. 262.

We conclude that the order appealed from should be and is

Affirmed.

No. 890

Office - Supreme Court,
FILED
APR 8 1957
JOHN T. FEY, Clerk

IN THE

United States Court of Appeals

FOR THE FOURTH CIRCUIT

No. 7304

RANDALL J. LEBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LeBoeuf, Lamb & Leiby,

Appellants,

v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, Debtor,

Appellee.

APPENDIX TO APPELLANTS' BRIEF

BREMNER, PARKER, NEAL, HARRIS & WILLIAMS,
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Richmond, Virginia.

W. GIBSON HARRIS, Esq.,
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HORACE R. LAMB, Esq.,
New York, N. Y.,

Of Counsel.

FILED

OCT 22 1956

R. M. F. WILLIAMS, JR.
CLERK

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Order Appealed From

IN THE

District Court of the United States

FOR THE EASTERN DISTRICT OF VIRGINIA

AT RICHMOND

In the Matter of CENTRAL STATES ELECTRIC CORPORATION, a corporation, *Debtor.*	Proceedings for the Reorganization of a Corporation No. 16-620

This matter came on further to be heard on the Petition dated December 7, 1955, of Messrs. LeBoeuf, Lamb & Leiby, petitioners, as assignees, for payment to them from the Debtor's assets of reasonable expenses, including attorneys' fees, allegedly payable under Article 6-A of the General Corporation Law of the State of New York, or, in the alternative, and in their own right, for such payment to them from the Debtor's assets, under the provisions of the Bankruptcy Act; and the Trustee of the above-named Debtor having filed, in opposition to said Petition, an Affidavit sworn to by Carl J. Austrian on January 4, 1956, and an Answer dated January 13, 1956;

And the matter having come on for hearing before this Court on March 9, 1956, and the Court having heard argument of counsel for petitioners, for the Trustees of the Debtor and for the Securities and Exchange Commission, and memoranda of law having been submitted by

the respective parties, and the Court having filed its opinion dated June 8, 1956; and after due deliberation and consideration;

Now, on motion of Austrian, Lance & Stewart, attorneys for the Trustees of the Debtor, it is hereby

ORDERED, ADJUDGED AND DECREED that the Petition be, and it hereby is dismissed.

s/s STERLING HUTCHESON

Dated: June 25, 1956.

Opinion

IN THE

United States District Court

FOR THE EASTERN DISTRICT OF VIRGINIA

RICHMOND DIVISION

In the Matter of CENTRAL STATES ELECTRIC CORPORATION, a Corporation, *Debtor.*	No. 16-620

In 1942 Central States Electric Corporation filed a petition in this Court for reorganization under Chapter X of the Bankruptcy Act. At that time the debtor had outstanding a large amount of debentures and preferred stocks. The market value of the assets, which consisted entirely of securities, reached a high of approximately $400,000,000.00 in 1929. At the time the petition was filed the value of its assets was approximately $1,300,000.00. The trustees originally appointed conducted an investigation which indicated a probable liability on the part of certain officers, directors and stockholders of the corporation for mismanagement, but recommended against the institution of suits. The recommendation was based principally upon the ground that recovery was barred by the statute of limitations. Furthermore, the assets in the

hands of the trustees were insufficient to pay the secured creditors who opposed the expenditure of assets in the prosecution of such actions which they believed would be barren of results. The District Court approved the recommendation of the trustees and a committee of preferred stockholders appealed. *Committee* v. *Kent,* 143 Fed. (2d), 684. The Court of Appeals reversed the District Court and directed a further investigation with the view of instituting suit against certain members of the former management. Thereafter the original trustees resigned and additional trustees were appointed. In conformity with the directions of the Court of Appeals, Fourth District, a further investigation was conducted and the new trustees recommended that suit be brought. The District Court thereupon entered an order authorizing the institution of such action. The suit was brought in the District Court for the Southern District of New York and a protracted and complicated proceeding developed. The District Court dismissed the complaint for lack of jurisdiction. *Austrian* v. *Williams,* 67 Fed. Supp. 223. The Court of Appeals, Second Circuit, reversed and remanded the case. 159 Fed. (2d) 67. The Supreme Court granted certiorari and affirmed the decision of the Court of Appeals, 330 U. S. 813, and 331 U. S. 642. The action thereupon came to trial on the merits and after a lengthy trial an opinion was filed setting forth detailed findings of fact. *Austrian* v. *Williams,* 103 Fed. Supp. 64.

Among the defendants were James F. Fogarty and Herbert C. Freeman, who were among the group in control of the affairs of the corporation prior to the filing of the petition. In the New York proceeding the action against these defendants, Messrs. Fogarty and Freeman, was dismissed solely by reason of the bar of the statute

of limitations, although the Court found that they failed to exercise due care or prudence in the discharge of liability and acted contrary to the interests of the corporation. 103 Fed. Supp., at 92. Judgment in excess of $15,000,000.00 was entered against the other defendants, which judgment was reversed by the Court of Appeals, Second Circuit. *Austrian* v. *Williams*, 198 Fed. (2d) 697; certiorari denied 344 U. S. 909. While the New York litigation was pending various reorganization plans were submitted to this Court and in 1950 a plan was submitted by the trustees which was approved. During the interval since the petition was filed the market value of the assets had increased to approximately $38,000,000.00, exclusive of the claims against the defendants in the New York litigation. In re: *Central States Electric Corporation*, 112 Fed. Supp. 281. See also *Central States* v. *Austrian*, 183 Fed. (2d), 879, and *Chase* v. *Austrian*, 189 Fed. (2d), 555. Since the consummation of the plan a number of cash distributions have been made to senior preferred stockholders but not enough to satisfy the claims in full and there are junior preferred stockholders with claims aggregating more than $30,000,000.00. Common stockholders will receive nothing. After the termination of the New York proceeding Messrs. Fogarty and Freeman filed application in the Federal Court in New York pursuant to Article 6-A of the General Corporation Law of New York, seeking a determination and assessment against the debtor for reasonable expenses and attorneys' fees incurred in defense of the action. The New York Court entered an order assessing against the debtor in favor of Fogarty and Freeman certain expenses and attorneys fees. The trustees appealed from that order and the Court of Appeals, Second Circuit, reversed and directed a dis-

missal in the District Court. *Austrian* v. *Williams,* 216 Fed. (2d), 278. The basis of the reversal was that jurisdiction concerning such allowances was in this Court as the reorganization court, but the Court specifically stated that the propriety of making the allowance was not passed upon.

Thereafter, petitioners in this proceeding, LeBoeuf, Lamb and Leiby, a firm of practicing attorneys in New York who represented Fogarty and Freeman in the New York litigation, applied to this Court for permission to accept an assignment of the claim asserted by Fogarty and Freeman in that proceeding. The basis of the application was *Section 249 of the Bankruptcy Act.* By an order dated December 7, 1955 the application was dismissed on the ground that the rights sought to be transferred or assigned were not claims against or stock of the debtor in contemplation of the Act. Thereupon petitioners accepted the assignment and filed a petition in this Court seeking compensation.

Counsel have presented exhaustive briefs upon the question for determination and the case has been ably argued orally. My conclusions can be briefly stated.

With respect to the application of *Article 6-A of the New York General Corporation Law,* it is to be borne in mind that this is a Chapter X proceeding. The proceeding in the District Court in New York was incident to the reorganization proceeding in this District and the Court there acquired jurisdiction under the Bankruptcy Act. *Williams* v. *Austrian,* 331 U. S. 647. In view of this it is my opinion that the New York law is not binding upon the reorganization court. Upon the contrary, the rights of petitioners are to be determined in accordance with the principles applicable in Federal Courts without refer-

ence to the state law. Petitioners contend alternatively that if they are not entitled to compensation under the New York law they are entitled to an allowance under *Chapter X of the Bankruptcy Act.* As I understand the provisions of the Act in this respect, as a prerequisite to an award by the reorganization court it must be shown that services so compensated have resulted in benefit to the estate. The facts here are that the petitioners were acting exclusively for the protection of their clients, Fogarty and Freeman. To contend that their services in defending the New York litigation advanced or benefited the reorganization proceeding is unsound reasoning. While it is true the termination of that proceeding was necessary for a final disposition of the reorganization proceeding, I am unable to agree with the contention that counsel for the defendants, seeking to avoid liability for certain claims asserted by the trustees, contributed anything to the reorganization. While due recognition is given to the equitable principles upon which the New York law regarding compensation is based and to the fact that Messrs. Fogarty and Freeman were not held liable for mismanagement of the affairs of the corporation, it is to be borne in mind that the plea of the statute of limitations is the only successful defense which was interposed.

It is my conclusion that the General Corporation Law of New York is not binding upon this Court and that the services performed by the petitioners are not compensable in this reorganization proceeding.

Therefore the petition will be dismissed.

/Sgd./ Sterling Hutcheson
United States District Judge

June 8, 1956

FILED
MAY 8 1957
JOHN T. FEY, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 890

RANDALL J. LEBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LEBOEUF, LAMB & LEIBY,

Petitioners,

—against—

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, Debtor,

Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR CERTIORARI

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

RANDALL J. LEBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LEBOEUF, LAMB & LEIBY, *Petitioners,* *—against—* CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, Debtor, *Respondent.*	No. 890

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR CERTIORARI

Opinions Below

The opinion (by District Judge Chesnut) of the Court of Appeals for the Fourth Circuit (before Chief Judge Parker, Circuit Judge Soper and District Judge Chesnut) is reported at 240 F. 2d 546 (1957). It is also printed in the Appendix to Petitioners' brief, at page 38.

The opinion of the United States District Court for the Eastern District of Virginia (the Reorganization Judge)

is not reported. It is printed at page 3 of the Appendix to Petitioners' (Appellants') brief in the Court of Appeals below and in the Appendix to the brief of the Securities and Exchange Commission in this Court.

Jurisdiction

The judgment of the Court of Appeals was entered on January 7, 1957. The petition for a writ of certiorari was filed on April 8, 1957. The jurisdiction of this Court is invoked under 28 U. S. Code, § 1254 (1).

Question Presented

Is a federal judge, administering the estate of a Virginia Corporation in the United States District Court for the Eastern District of Virginia under Chapter X of the Bankruptcy Act, in passing on an application by former directors of the Debtor for fees and expenses incurred by them in defeating, on the ground of statute of limitations, an action for breach of fiduciary duty brought against them by the Reorganization Trustees of the Debtor in the United States District Court for the Southern District of New York, *required* to apply a New York statute governing reimbursement of litigation expenses?

Statement of Case

Petitioners were attorneys for and are the assignees of two individuals, Fogarty and Freeman, who were sued, among others, in a plenary action brought by respondent (and his co-Trustee, now deceased) as Reorganization Trustees of the Debtor in the United States District Court for the Southern District of New York. Central States Electric Corporation, a Virginia corporation, is the Debtor

in a reorganization proceeding under Chapter X of the Bankruptcy Act in the Eastern District of Virginia. The Debtor was an investment company, whose assets in 1929 were worth about $400,000,000. In February 1942 their worth had shrunk to about $1,300,000, causing the Debtor to file a petition for reorganization under Chapter X.

The present Trustee and Robert G. Butcher were appointed Trustees in 1944-1945, and after making an investigation as directed by the Court of Appeals for the Fourth Circuit (*Committee for Holders, etc.* v. *Kent,* 143 F. 2d 684 (1944)) and obtaining authorization from the Reorganization Judge, instituted a plenary action in the United States District Court for the Southern District of New York (hereinafter referred to as the "Trial Court"). There were many defendants, including Harrison Williams, the controlling stockholder. No diversity of citizenship of the parties was alleged. Jurisdiction was founded upon the provisions of Article I, Section 8, Clause 4, and Article III, Section 2, of the Constitution of the United States and the Bankruptcy Act, particularly Section 2(a) 7 (11 U. S. C. A. § 11(a)(7)). The defendants' opposition to the jurisdiction of the New York District Court over the action was sustained by the District Court (*Austrian, et al.* v. *Williams, et al.,* 67 F. Supp. 223 (1946)). The Court of Appeals for the Second Circuit reversed (159 F. 2d 67 (1946)) and this Court affirmed (*Williams, et al.* v. *Austrian, et al.,* 331 U. S. 642 (1947).)

The complaint alleged that the defendants, including Fogarty and Freeman, former directors of the Debtor, had over-reached the Debtor and looted it in a series of transactions. After protracted litigation, the Trial Court found, with respect to three causes of action, that Fogarty and Freeman, acting under the domination of Williams, had failed to exercise due care and prudence in discharge of

their responsibilities to Central States and had acted contrary to the interest of Central States, and that plaintiffs were entitled to recovery against them on these three transactions in the amount of $748,122.24 in respect of Fogarty and $593,693.44 in respect of Freeman. The Trial Court determined, however, that recovery against the defendants Fogarty and Freeman was barred by limitations (103 F. Supp. 64, at p. 117 (1952)) and entered a judgment dismissing the complaint against Fogarty and Freeman.*

Subsequently, Fogarty and Freeman applied to the Trial Court for allowance of their expenses including attorneys' fees incurred by them in the defense of the Trustees' action. This application was based on Section 64 of Article 6-A of the General Corporation Law of New York. The Trial Court, which had conducted the trial of the Trustees' action, acting under the erroneous impression that it was absolutely constrained by the New York statute to grant the application, allowed Fogarty and Freeman $30,000 for attorneys' fees and $1,185.53 for disbursements. It was not then brought to the Trial Court's attention that Petitioners had theretofore been paid $25,000 by Fogarty and Freeman "on account" of fees for services rendered to them by petitioners.**

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*A judgment was entered against Harrison Williams and another defendant which was subsequently reversed by the Court of Appeals for the Second Circuit on the ground of statute of limitations (*Austrian, et al.* v. *Williams, et al.*, 198 F. 2d 697 (2d Cir. 1952).) Petition for certiorari was denied by this Court (344 U. S. 909 (1952).) However, neither Fogarty or Freeman nor the Trustees of the Debtor appealed from the judgment against Fogarty and Freeman.

**Neither the Reorganization Judge nor the Court below dealt with the right of Petitioners to compensation under the New York statute on the assumption that the New York statute might be applicable. The Trial Court, under the erroneous impression, first, that it was constrained to apply the New York law and, second, that under New York law it was mandatory to grant an allowance, did so. Subsequent decisions established beyond question that the Trial Court was in error not only in believing that it was required to apply

The Trustees appealed to the Court of Appeals for the Second Circuit from the order of the Trial Court granting the allowance to Fogarty and Freeman. The Court of Appeals for the Second Circuit reversed the Trial Court's order, holding that the question of allowances to be paid in a reorganization proceeding was within the exclusive jurisdiction of the Reorganization Judge in charge of the Debtor's estate and that the Trial Court's order granting the allowances was an incursion upon the exclusive power of the Reorganization Judge. On reargument, the Court of Appeals expanded on the point, declaring that any allowance made would be payable by the Debtor, arose out of a lawsuit that had represented a contingent asset of the Debtor's estate, and that the allowance was connected with the plan and incident to the reorganization. As such and "being fixable after confirmation of the plan, they were 'subject to the approval of the [reorganization] judge'" (216 F. 2d 278 (1954).) A petition for a writ of certiorari was denied by this Court (*Fogarty, et al.* v. *Austrian, et al.*, No. 550, 348 U. S. 953 (1955)).

Thereafter, Fogarty and Freeman assigned their rights to such reimbursement to Petitioners, who applied to the Reorganization Court for allowances as assignees under Article 6-A of the New York General Corporation Law, and, alternatively, in their own right for allowances under Chapter X of the Bankruptcy Act.* After a hearing, the Reorganization Judge (Judge Hutcheson) dismissed the

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the New York law, but also that it had no discretion even under New York law to deny the application because of the wrongdoing of Fogarty and Freeman. *Austrian, et al.* v. *Williams, et al.*, 216 F. 2d 278 (1954); *Diamond* v. *Diamond*, 307 N. Y. 263 (1954). We believe that not only were Petitioners not entitled to any compensation under the Bankruptcy Law but were not entitled to compensation under the New York law because of the wrongdoing of their assignors.

*The claim of Petitioners to compensation on this latter alternative ground is not being urged before this Court.

petition, holding that Article 6-A of the New York General Corporation Law was not binding on the Reorganization Court, but, on the contrary, the rights of Petitioners to compensation must be determined in accordance with principles applicable under bankruptcy law without reference to state law. As to the alternative contention that Petitioners were entitled to compensation under the Bankruptcy Act, the Reorganization Judge held that the efforts of Petitioners on behalf of their clients to avoid liability for claims asserted against them by the Reorganization Trustees contributed nothing to the reorganization and that these services had not resulted in any benefit to the estate of the Debtor. The Reorganization Judge further pointed out that, while Fogarty and Freeman had escaped a money judgment for mismanagement of the affairs of the Debtor, it was only because of the statute of limitations.

Petitioners thereupon appealed to the United States Court of Appeals for the Fourth Circuit, which affirmed the order of the Reorganization Judge holding that the New York statute was not controlling on the Reorganization Judge; that the petition for allowances must be governed by the provisions of Chapter X of the Bankruptcy Act; that there was no basis under the Bankruptcy Act for an allowance to Petitioners because their assignors, Fogarty and Freeman, had acted adversely to the interests of the Debtor's estate, and that they had no interest either in opposition to or in the success of the reorganization plan. It should be noted also that the Court below stressed the fact that not only was there complete justification for the bringing of the action by the Trustees against Fogarty and Freeman, but that recovery against them failed "by reason only of the successful defense of limitations, as to a very large amount of damages awarded." (Pet. for Cert., App., p. 52.)

Argument

I.

THE DECISION OF THE COURT BELOW DOES NOT WARRANT FURTHER REVIEW BECAUSE IT IS CLEARLY CORRECT, RAISES NO NOVEL QUESTION, AND IS NOT CONTRARY TO OR IN CONFLICT WITH DECISIONS OF THIS COURT OR OTHER COURTS OF APPEAL.

Over a period of years, this Court has made it plain in a series of cases that the business of fixing allowances in a reorganization proceeding under Chapter X of the Bankruptcy Act is the peculiar province of the Reorganization Judge. In determining applications for allowances, the Reorganization Judge must, while exercising a sound discretion, look to and adhere to the provisions of the Bankruptcy Act and the standards set up by this Court regarding allowances. This Court has held that if the Bankruptcy Act is to be administered uniformly throughout the country, the judgment of the Reorganization Judge in fixing allowances must not be hampered—to say nothing of being controlled—by the requirements or provisions of a particular state law, whose provisions might or might not be different from those of the Bankruptcy Act, whose standards might or might not be different from those established by this Court. *Brown, et al.* v. *Gerdes, et al.*, 321 U. S. 178 (1944); *Leiman, et al.* v. *Guttman, et al.*, 336 U. S. 1 (1949); *Callaghan* v. *Reconstruction Finance Corporation*, 297 U. S. 464 (1936), *Vanston Committee* v. *Green*, 329 U. S. 156 (1946); *Pepper* v. *Litton*, 308 U. S. 295 (1939).

In *Vanston Committee* v. *Green, supra*, this Court said, at pages 162-163:

> "In determining what claims are allowable and how a debtor's assets shall be distributed, a bank-

> ruptcy court does not apply the law of the state where it sits. *Erie R. R.* v. *Tompkins,* 304 U. S. 64, has no such implication. That case decided that a federal district court acquiring jurisdiction because of diversity of citizenship should adjudicate controversies as if it were only another state court. See *Holmberg* v. *Armbrecht,* 327 U. S. 392. But bankruptcy courts must administer and enforce the Bankruptcy Act as interpreted by this Court in accordance with authority granted by Congress to determine how and what claims shall be allowed under equitable principles."

In *Pepper* v. *Litton, supra,* this Court held that a reorganization judge had power to disallow or subordinate a claim based on a judgment procured in a state court by an officer of the debtor in reorganization proceedings, because the officer was found guilty by the reorganization judge of improper conduct. This Court stated:

> "In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder. That is clearly the power and duty of the bankruptcy courts under the reorganization sections." (pp. 307-8)

This Court stated in *Brown* v. *Gerdes, supra,* at page 182, as follows:

> "In all cases persons who seek compensation for services or reimbursement for expenses are held to fiduciary standards. § 249; *Woods* v. *City National Bank Co.,* 312 U. S. 262, 267-269. And § 250 contains special appeal provisions governing orders granting or denying allowances. *Dickinson Industrial Site* v. *Cowan, supra.* Moreover a plan of reorganization must provide 'for the payment of all costs

and expenses of administration and other allowances which may be approved or made by the judge.' § 216(3). In addition the plan must provide, in furtherance of the purpose of the Act to protect the security holders against previous acts of mismanagement and to preserve all assets of the estate (S. Rep. No. 1916, 75th Cong., 3d Sess., p. 22; H. Rep. No. 1409, *supra,* pp. 42-44), for retention and enforcement by the trustee of all claims of the debtor or the estate not settled or adjusted in the plan. § 216(13). Finally, § 221(4) provides that in approving any plan the judge must be satisfied that 'all payments made or promised' by the debtor, the new company, or any other person, 'for services and for costs and expenses' are not only fully disclosed but 'are reasonable or, if to be fixed after confirmation of the plan, will be subject to the approval of the judge.' "

These decisions of this Court show that the decision of the Court below is neither novel nor in conflict with prior decisions of this Court. The decision of the Court below deals with the kind of problem that was dealt with in the decisions of this Court cited above. It deals with the character of persons entitled to compensation in a reorganization proceeding, the circumstances under which compensation is allowed, the standards applicable, and it stresses the well-established rule that allowances are subject to the approval of the reorganization judge. Both the Reorganization Judge and the Court below had before them an application for allowances by persons who not only did not contribute to the Plan of Reorganization of the Debtor, but whose sole interest in the estate was hostile, and who had been found by both the Trial Court and the Reorganization Judge to be wrongdoers with respect to the Debtor. Under the circumstances, there was no other course for the Reorganization Judge to pursue under the provisions of the Bankruptcy Act but to hold that these Petitioners are not entitled to compensation from the estate of the Debtor.

The decision of the Court below affirming the judgment of the Reorganization Judge is entirely consistent and in accord with the decisions of this Court.

Not only does the Bankruptcy Act specify in particular sections who may be entitled to compensation in a reorganization proceeding (§§ 221(4), 241(3), 242 and 243 of Chapter X (11 U. S. C. A., §§ 621(4), 641(3), 642 and 643)), but the reorganization judge must, under § 221(4) of the Bankruptcy Act, in approving any plan, be satisfied that "all payments made or promised by the debtor * * * for services and for costs and expenses" are reasonable and subject to the approval of the judge. Obviously, this statutory scheme is meaningless if, in fixing fees, the reorganization judge is required to apply a state statute. It would mean that the judgment and discretion of the reorganization judge is gone. It would mean that the standards prescribed by this Court in a whole series of cases for the reorganization judge are no longer those of this Court but those of any of the forty-eight states. This Court has consistently held otherwise. *Dickinson Co.* v. *Cowan,* 309 U. S. 382 (1940); *Woods* v. *City National Bank Co.,* 312 U. S. 262 (1941).

The fact that the Trustees' action was brought in the United States District Court for the Southern District of New York does not affect the right and power of the Reorganization Judge to determine allowances by Chapter X standards. It should be borne in mind, in the first place, that the action of the Trustees in the federal court was based not on diversity of citizenship but on the bankruptcy statute. In that respect, the action of the Trustees was entirely different from *Cohen, Executrix, et al.* v. *Beneficial Industrial Loan Corp.,* 337 U. S. 541 (1949), where the jurisdiction of the federal court rested on diversity of citizenship and the federal court was, therefore, sitting as an alter ego of the state court. And what is more important,

Cohen v. *Beneficial Loan Corp., supra,* did not involve the payment of fees out of an estate in Chapter X proceedings.

Nor is the argument of petitioners that state-created rights were sought to be enforced by the Trustees in the plenary action against Fogarty and Freeman of any consequence in a consideration of the question whether Fogarty and Freeman or their assignees are entitled to compensation from the estate of the Debtor under the Bankruptcy Law. Petitioners overlook entirely the difference, on the one hand, between the character of the right of the Trustees of the Debtor to compel an accounting by delinquent directors of the Debtor, and the right, on the other hand, of assignees of these delinquent directors to be paid fees by the Reorganization Court. These latter rights are not only completely different from but totally separate and independent of the former rights. That being so, the Reorganization Judge, in line with well-established principles of this Court, finding that these delinquent directors or their assignees had made no contribution to the Plan of Reorganization, that their position was hostile to that of the Debtor, and that these directors were found to be derelict in their duties to the Debtor but had escaped liability solely by virtue of the running of the statute of limitations, could not do anything except exercise a sound and wise discretion in denying the application for allowances.

For the purposes of this application, we do not have to discuss *National Mutual Insurance Co.* v. *Tidewater Transfer Co., Inc.,* 337 U. S. 582 (1949), dealt with at great length in Point II of Petitioners' brief. Nor do we have to argue the question urged by Petitioners that the right of the Trustees against delinquent directors of the Debtor rests on state law, because that is not germane to the question presented on this application. The fact is that whatever the character of the right of the Trustees against the delinquent directors may be—whether federal or state—the right of the

delinquent directors or their assignees to allowances in the reorganization court is clearly a matter of Chapter X law. The right to these allowances is a question separate and apart from the right of the Trustees against the delinquent directors. The two questions have no connection.

In Point II of their argument, Petitioners state that the Court below erroneously held that the New York statute was not applicable to the plenary action in the District Court, citing *Fielding* v. *Allen,* 181 F. 2d 163 (2d Cir., 1950). Petitioners suggest that this is in conflict with the statements of this Court in *National Ins. Co.* v. *Tidewater Co., supra.* A reading of the opinion of the Court below makes it clear that its reference to *Fielding* v. *Allen, supra,* was not with respect to the question raised in *National Ins. Co.* v. *Tidewater Co., supra.* The Court below was referring to the argument of Petitioners below that, on an application for compensation of this character, state law controls, under the authority of *Cohen* v. *Beneficial Loan Corp., supra.* The Court below pointed out that *Cohen* v. *Beneficial Loan Corp.* was a case involving jurisdiction based on diversity of citizenship, and that that was the reason why the New Jersey law was applied. The Court below referred to *Fielding* v. *Allen, supra,* not as a ground for decision in this case, but as an example of a type of case where the decision of *Cohen* v. *Beneficial Loan Corp., supra,* will not apply, i.e., a case where an action in the federal court is not governed by state rules. However, the ground of the decision of the Court below was not *Fielding* v. *Allen, supra,* or a doctrine that the action brought by the Trustees rested on federal rights, but that the application for compensation was something separate and apart from the action of the Trustees, was a bankruptcy matter, and as such must be governed only by that law.

There is no conflict between the decision of the Court below and the decision of the Court of Appeals for the

Seventh Circuit in *In re Granada Apartments, Inc.*, 155 F. 2d 882 (1946), cert. den. 329 U. S. 785 (1946). In one respect, the decisions reached by both Courts of Appeal were identical in that in each case the disposition of the reorganization judge of a claim for legal fees was affirmed by the Court of Appeals as a proper exercise of the broad judicial discretion vested in him by Chapter X.*

In *Granada,* the petitioner was an indenture trustee which, after managing the property, turned it over to the reorganization trustee. The indenture trustee filed a claim for services rendered in the reorganization proceeding. The Chapter X trustee opposed the claim on the ground that the indenture trustee had represented conflicting interests and, in a counterclaim, asserted charges of maladministration on the part of the indenture trustee. These claims and counterclaims were tried by the reorganization judge in a plenary proceeding. The District Court ultimately awarded the indenture trustee its fees and expenses incurred in defending itself with respect to the administration of the estate in its possession.

Several facts must be noted about the *Granada* case. In the first place, the indenture trustee had a right to request compensation under § 242(1) of the Bankruptcy Act (11 U. S. C. A. § 642(1)). In the second place, the indenture trustee was acquitted of any charge of misconduct. In the third place, the indenture trustee had a lien on the assets turned over to the Chapter X trustee for compensation for services rendered in connection with those assets. This was a lien well established under equity law and perfected before the indenture trustee turned over the assets to the Chapter X trustee. The indenture trustee was appealing to the reorganization judge as a matter of equity, which was entirely consistent with the principles of Bank-

*In *Granada,* the Reorganization Judge was actually reversed because he erroneously computed the amount of the fee.

ruptcy Law. *Vanston Committee* v. *Green, supra.* On the other hand, in the instant case, neither Petitioners nor their assignors were parties to the reorganization proceeding; they did not have any connection with the Plan of Reorganization; they did not render any services except in litigating against the Trustees; and finally, they were held guilty of misconduct not only by the Trial Court but by the Reorganization Judge.

The two cases are entirely different and there is not the slightest conflict between the two decisions.

II.

THE PETITION FOR CERTIORARI SHOULD BE DENIED.

Respectfully submitted,

SAUL J. LANCE,
Attorney for Respondent.

MELVIN KRAFT,
Of Counsel.

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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 890

RANDALL J. LEBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LeBoeuf, Lamb & Leiby, *Petitioners*

v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, a Corporation, Debtor

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On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fourth Circuit

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BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION[1]

OPINIONS BELOW

The opinion of the Court of Appeals (Pet. 38-54)[2] is reported at 240 F. 2d 546. The opinion of the Dis-

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[1] The Securities and Exchange Commission is a party to the reorganization in the District Court pursuant to Section 208 of the Bankruptcy Act (52 Stat. 894) and participated as an appellee in the Court of Appeals.

[2] "Pet. . . . ." refers to pages of the petition or the appendix attached thereto.

trict Court is not reported. It is set forth in the appendix, *infra,* at pp. 12-16.

JURISDICTION

The judgment of the Court of Appeals (Pet. 2) was entered on January 7, 1957. The petition for a writ of certiorari was filed on April 8, 1957. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the reorganization court in a proceeding under Chapter X of the Bankruptcy Act must apply a state indemnification statute, which requires payment by a corporation of reasonable legal fees and expenses incurred by its officers and directors who have successfully defended an action brought against them, when former corporate officials of the debtor have escaped liability for mismanagement in an action brought by the reorganization trustee by reason of the running of the statute of limitations of the jurisdiction where service could be effected upon them.

STATUTES INVOLVED

Chapter X of the Bankruptcy Act, 52 Stat. 883, *et seq.,* and particularly Sections 167(3), 221(4), 241, 242 and 243, are involved in this proceeding, as well as Article 6-A of the New York General Corporation Law, N. Y. Sess. Law 1945, c. 869 § 4. These statutes are included in the appendix to the petition (Pet. 30-37), except Section 167(3) of the Bankruptcy Act, which is set out in the appendix hereto, *infra,* p. 12.

STATEMENT

The trustees of Central States Electric Corporation, which has been in reorganization in the United States District Court for the Eastern District of Virginia under Chapter X of the Bankruptcy Act, brought an action in the United States District Court for the Southern District of New York against the debtor's controlling stockholder and others, including James F. Fogarty and Herbert C. Freeman, the assignors of the petitioners herein.[3] The action, based essentially upon acts of mismanagement, was dismissed as to Fogarty and Freeman, although it was found that while officials of the debtor they had acted contrary to its interests and the dismissal as to several of the counts was solely by reason of the running of the statute of limitations. See *Austrian* v. *Williams,* 103 F. Supp. 64, 92, 96-97, 101 (S.D. N.Y.), reversed, 198 F. 2d 697 (C.A. 2), certiorari denied, 344 U.S. 909.

Fogarty, Freeman, and other defendants in the trustees' action in the United States District Court for the Southern District of New York filed applications in that court after the action had terminated seeking the determination and assessment against the debtor of their reasonable expenses and attorneys' fees pursuant to Article 6-A of the General Corporation Law of New York. With respect to Fogarty and Freeman the court assessed attorneys' fees at $30,000 and disbursements at $1,185.53, believing that the decision of the Court of Appeals for the Second Circuit in *Austrian*

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[3] That matter was before this Court in *Williams* v. *Austrian,* 331 U.S. 642.

v. *Williams*, 198 F. 2d 697 (C.A. 2), with respect to the application of the New York statute of limitations, required a similar holding with respect to Article 6-A of the New York General Corporation Law.[4] On appeal, the Court of Appeals for the Second Circuit held that this was "a mistaken view" of its decision; it did not decide, however, the question whether Article 6-A should be applied, holding that the determination of such a question "was a function belonging exclusively to the Virginia Reorganization Court."[5]

Thereafter, the claims of Fogarty and Freeman for legal services and disbursements were assigned to petitioners, the attorneys who performed the services. They filed a petition in the reorganization court seeking an allowance from the debtor's estate upon the ground that the reorganization court was required by Article 6-A of the New York General Corporation Law to award allowances to petitioners, as assignees of the successful defendants in the action brought in the federal District Court in New York, or, alternatively, that petitioners' services in defending against the trustees' action were compensable as administration expenses of the debtor's estate. The reorganization court dismissed the petition, holding that neither alternative justified an award of fees to the petitioners out of the Chapter X estate, and the court below affirmed both holdings. Petitioners seek review here of the determination that the New York statutory provision is not controlling, but do not seek review in this Court of their alternative contention (Pet. 17).

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[4] *Austrian* v. *Williams*, 120 F. Supp. 900, 903-904 (S.D. N.Y.).

[5] *Austrian* v. *Williams*, 216 F. 2d 278, 281 (C.A. 2), certiorari denied *sub nom. Fogarty* v. *Austrian*, 348 U.S. 953.

ARGUMENT

The determination of both courts below that the New York statutory provision for indemnification of corporate officials should not be applicable to the debtor in proceedings under Chapter X of the Bankruptcy Act is clearly correct, does not conflict with the result reached by any other court, and requires no review by this Court. Other questions sought to be raised by the petition (Pet. 3) are not presented in the instant case.

1. Sections 241, 242 and 243 of Article XIII set forth the services which are compensable from the Chapter X estate. Under these sections services are compensable only if they result in a benefit to the estate.[6] As stated in *Dickinson Industrial Site, Inc.* v. *Cowan*, 309 U.S. 382, 389:

> Fee claimants are either officers of the court or fiduciaries, such as members of committees, whose claims for allowance from the estate are based only on service rendered to and benefits received by the estate. [Footnotes omitted.]

The court below found that petitioners' services were not compensable under these sections (Pet. 49-52) and petitioners specifically state that they do not seek review of that determination (Pet. 17).

But unless awards for the services involved are authorized by the foregoing sections, they may not be paid. The court below implicitly, (Pet. 50-51) and the Court of Appeals for the Second Circuit[7] explicitly, have held that the claims for legal expenses here involved are "for services and for costs and expenses"

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[6] See 6 Collier on *Bankruptcy*, 14th ed. (1947) ¶ 13.02.

[7] *Austrian* v. *Williams*, 216 F. 2d 278, 283-284 (C.A. 2).

within the meaning of Section 221(4) of the Bankruptcy Act, which section provides that the reorganization court must pass upon the reasonableness of all payments therefor. And *Brown* v. *Gerdes,* 321 U.S. 178, 182, makes clear that the "detailed machinery" of Chapter X governs all claims under Section 221(4) for allowances from the estate.

Brown v. *Gerdes, supra,* held that Section 475 of the New York Judiciary Law, providing for the creation and enforcement of an attorney's lien on the recovery of a lawsuit, was not applicable to an action brought by a Chapter X trustee in the New York State courts. In stating that Chapter X contained the exclusive provisions for payments of legal fees out of the estate, this Court referred to "the establishment of more effective control over reorganization fees and expenses . . . in recognition of the effect which a depletion of the cash resources of the estate may have on both the fairness and feasibility of the plan of reorganization" (321 U.S. at 181). It also referred to "the purpose of the Act to protect the security holders against previous acts of mismanagement and to preserve all assets of the estate," noting that Section 216 (13) specifically provides "for retention and enforcement by the trustee of all claims of the debtor or the estate not settled or adjusted in the plan" (*id.* at 182).

These considerations are equally applicable here. As noted by the court below, application of the New York statute here involved would be contrary to the aim of Congress "to reasonably minimize the expenses of administration" (Pet. 48).[8] The court also re-

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[8] *Cf. Callaghan* v. *Reconstruction Finance Corporation,* 297 U.S. 464, 469.

ferred to Section 167 of the Bankruptcy Act which requires the independent trustee to "report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate." As this Court noted in *Williams* v. *Austrian,* 331 U.S. 642, 657, the Senate Committee report on the Chandler Act stated that this provision "insured the 'prosecution of all causes of action.' "

Prosecution of such actions against former officials, which have resulted in substantial recoveries for debtors in reorganization, will not be "insured" if a state may impose upon the debtor's estate substantial expenses in the event the action should ultimately prove unsuccessful. Indeed, in the instant reorganization proceeding, the possibility of loss to security holders by the amount of the trustee's litigation expenses in the event the action should be unsuccessful deterred the original trustees from recommending the institution of actions against the former officials of the company. *Committee for Holders, etc.* v. *Kent,* 143 F. 2d 684, 685 (C.A. 4). Although the action was ultimately unsuccessful, the district judge had awarded a judgment in excess of $14,000,000 with interest from 1929 on behalf of the estate against two of the defendants thereto, and the appellate court was not unanimous in reversing that judgment.

Accordingly, the state statute here involved was properly held inapplicable to the extent that it would permit claims "for services and for costs and expenses" within the meaning of Section 221(4) to be paid from the estate contrary to the provisions of Article XIII of the Bankruptcy Act, which this Court held in *Brown* v. *Gerdes, supra,* to be exclusive, and

contrary to important purposes of Chapter X, which that case held must prevail over provisions of state law.

Stellwagen v. *Clum,* 245 U.S. 605, 614-615, from which petitioners quote at length (Pet. 14-15), held that the state statute there involved, which was "intended . . . to promote the equal distribution of insolvent estates," was "not opposed to the policy of the bankruptcy law." The Court noted: "It is only state laws which conflict with the bankruptcy laws of Congress that are suspended; those which are in aid of the Bankruptcy Act can stand." This is wholly consistent with the opinion of the court below, which noted that it is "contrary to the manifest policy of Chapter 10 to subject and hamper its provisions by a State statute which would authorize awarding fees and expenses to defendants sued for recovery of assets of the corporation whether the suits are successful or not." (Pet. 48).

Cohen v. *Beneficial Loan Corp.,* 337 U.S. 541, relied on by the petitioners (Pet. 13), had no connection with the Bankruptcy Act and there was no conflict in that case with the provisions of any federal law.

Harrigan v. *Bergdoll,* 270 U.S. 560, and *Austrian* v. *Williams,* 198 F. 2d 697 (C.A. 2), cited by petitioners (Pet. 16), held that a state statute of limitations applies to an action brought by a bankruptcy trustee, but, as noted in the latter case, there is a specific provision in the Bankruptcy Act under which a state statute of limitations applies.[9] With reference to the language quoted from the *Harrigan* case, we do not

[9] See *Austrian* v. *Williams,* 198 F. 2d 697, 699 (C.A. 2), where Section 11(e) of the Bankruptcy Act is quoted. And see *Austrian* v. *Williams,* 216 F. 2d 278, 281 (C.A. 2).

suggest that the trustees' cause of action is different from that which the corporation itself might have enforced. We urge only that the indemnity provision is not an integral condition to the enforcement of the cause of action brought by the trustees, which was based upon general equitable principles,[10] and, being in conflict with the policies of the Bankruptcy Act, it may not be held applicable.

In re Granada Apartments, 155 F. 2d 882 (C.A. 7), certiorari denied, 329 U.S. 785, also relied upon in the petition (Pet. 24-27), was expressly distinguished by the court below. In that case there was reliance not on a state statute passed to indemnify directors, but, as the court below noted, upon a specific "contractual right to deduct from the property or funds" in the possession of the indenture trustee its reasonable expenses for successfully defending itself with respect to its duties, and upon the equitable principle "that a trustee in possession is entitled to be allowed from the fund in his possession expenses incurred in defending the trust committed to its charge, including reasonable compensation for services and expenses" (Pet. 53-54). There is no equitable principle that requires payment of compensation to former directors of the debtor corporation in accordance with a state indemnification statute (passed long after the directors

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[10] Even assuming arguendo (but see pp. 10-11, *infra*) that the trustees' cause of action had been based on the New York General Corporation Law (see Article 6, quoted at Pet. 29-30), it would not necessarily follow that application of the indemnity provisions was a necessary concomitant thereto. Cf. *Brown* v. *Gerdes,* 321 U.S. 178, 186: "The fact that New York has adopted measures designed to protect attorneys practicing in its courts does not demonstrate that New York has made its control over the fees a condition to the use of its tribunals."

had resigned) where they required the debtor's trustees to sue them in a jurisdiction other than where the debtor's affairs were being administered so that they might seek the shelter of a favorable statute of limitations. The petition points out (Pet. 11) that the policy of the indemnification statute "is to induce capable men to assume corporate directorships and overcome the fear of having to defend groundless actions at their own expense". As noted by the court below, "suits not based on probable cause should not be authorized by the Reorganization Judge and cannot be instituted without his order of approval" (Pet. 48).

2. The first two questions set forth in the petition (Pet. 3) are bottomed upon the assumption that the court below held that the Chapter X trustees' causes of action against the petitioners' assignors were based on "federal substantive law" or on "federal doctrines of general equity jurisprudence" (Pet. 3). These holdings are alleged to conflict with *Williams* v. *Austrian*, 331 U.S. 642 (Pet. 23). As the foregoing discussion makes clear, no such holding was necessary to the ultimate determination of the court below, and we submit that the court's opinion, read in its entirety, merely points out that the "substantive right of action" that the trustees sought to enforce in the United States District Court in New York was not created by the New York statute pursuant to which petitioners seek legal fees out of the estate, but was based on general equitable principles which would have been applicable wherever the action had been brought. To the extent that the New York statute authorizes an action against directors and officers of a corporation to compel them to account for official mis-

conduct, as the Court of Appeals noted, it "is merely a reflection but not a creation of the substantive equitable rights contained in equity jurisprudence" (Pet. 45). Hence, the court's opinion is not inconsistent with the quotation in the petition (Pet. 20) from *Williams* v. *Austrian*, 331 U.S. 642, 667, that the cause of action was "essentially State litigation." "State litigation" does not exclude causes of action which are transitory in nature—the characterization of the trustees' cause of action in *Committee for Holders, etc.* v. *Kent*, 143 F. 2d 684, 687 (C.A. 4). And see *Austrian* v. *Williams*, 198 F. 2d 697, 699-700 (C.A. 2), where the Court of Appeals for the Second Circuit, in applying the New York statute of limitations to the trustees' action, indicated its view that "the causes of action may have arisen under Virginia law."

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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Assistant General Counsel,

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Attorney, Securities and Exchange Commission,

MAY 1957.

APPENDIX

Section 167 of the Bankruptcy Act (52 Stat. 890) provides in pertinent part:

"The trustee upon his appointment and qualification—

> "(1) shall, if the judge shall so direct, forthwith investigate the acts, conduct, property, liabilities, and financial condition of the debtor, the operation of its business and the desirability of the continuance thereof, and any other matter relevant to the proceeding or to the formulation of a plan, and report thereon to the judge;
>
> "(2) may, if the judge shall so direct, examine the directors and officers of the debtor and any other witnesses concerning the foregoing matters or any of them;
>
> "(3) shall report to the judge any facts ascertained by him pertaining to fraud, misconduct, mismanagement and irregularities, and to any causes of action available to the estate;
>
> * * *

Opinion of the United States District Court for the Eastern District of Virginia

No. 16-620

In the Matter

of

CENTRAL STATES ELECTRIC CORPORATION,
a Corporation, *Debtor.*

In 1942 Central States Electric Corporation filed a petition in this Court for reorganization under Chapter X of the Bankruptcy Act. At that time the debtor had outstanding a large amount of debentures and preferred stocks. The market value of the assets, which consisted entirely of securities, reached a high of

approximately $400,000,000.00 in 1929. At the time the petition was filed the value of its assets was approximately $1,300,000.00. The trustees originally appointed conducted an investigation which indicated a probable liability on the part of certain officers, directors and stockholders of the corporation for mismanagement, but recommended against the institution of suits. The recommendation was based principally upon the ground that recovery was barred by the statute of limitations. Furthermore, the assets in the hands of the trustees were insufficient to pay the secured creditors who opposed the expenditure of assets in the prosecution of such actions which they believed would be barren of results. The District Court approved the recommendation of the trustees and a committee of preferred stockholders appealed. *Committee* v. *Kent,* 143 Fed. (2d), 684. The Court of Appeals reversed the District Court and directed a further investigation with the view of instituting suit against certain members of the former management. Thereafter the original trustees resigned and additional trustees were appointed. In conformity with the directions of the Court of Appeals, Fourth District, a further investigation was conducted and the new trustees recommended that suit be brought. The District Court thereupon entered an order authorizing the institution of such action. The suit was brought in the District Court for the Southern District of New York and a protracted and complicated proceeding developed. The District Court dismissed the complaint for lack of jurisdiction. *Austrian* v. *Williams,* 67 Fed. Supp. 223. The Court of Appeals, Second Circuit, reversed and remanded the case. 159 Fed. (2d) 67. The Supreme Court granted certiorari and affirmed the decision of the Court of Appeals, 330 U. S. 813, and 331 U. S. 642. The action thereupon came to trial on the merits and after a lengthy trial an opinion was filed setting forth detailed findings of fact. *Austrian* v. *Williams,* 103 Fed. Supp. 64.

Among the defendants were James F. Fogarty and Herbert C. Freeman, who were among the group in control of the affairs of the corporation prior to the filing of the petition. In the New York proceeding the action against these defendants, Messrs. Fogarty and Freeman, was dismissed solely by reason of the bar of the statute of limitations, although the Court found that they failed to exercise due care or prudence in the discharge of liability and acted contrary to the interests of the corporation. 103 Fed. Supp., at 92. Judgment in excess of $15,000,000.00 was entered against the other defendants, which judgment was reversed by the Court of Appeals, Second Circuit. *Austrian* v. *Williams,* 198 Fed. (2d) 697; certiorari denied 344 U. S. 909. While the New York litigation was pending various reorganization plans were submitted to this Court and in 1950 a plan was submitted by the trustees which was approved. During the interval since the petition was filed the market value of the assets had increased to approximately $38,000,000.00, exclusive of the claims against the defendants in the New York litigation. In re: *Central States Electric Corporation,* 112 Fed. Supp. 281. See also *Central States* v. *Austrian,* 183 Fed. (2d), 879, and *Chase* v. *Austrian,* 189 Fed. (2d), 555. Since the consummation of the plan a number of cash distributions have been made to senior preferred stockholders but not enough to satisfy the claims in full and there are junior preferred stockholders with claims aggregating more than $30,000,000.00. Common stockholders will receive nothing. After the termination of the New York proceeding Messrs. Fogarty and Freeman filed application in the Federal Court in New York pursuant to Article 6-A of the General Corporation Law of New York, seeking a determination and assessment against the debtor for reasonable expenses and attorneys' fees incurred in defense of the action. The New York Court entered an order assessing against the debtor in favor of Fogarty and Freeman certain ex-

penses and attorneys fees. The trustees appealed from that order and the Court of Appeals, Second Circuit, reversed and directed a dismissal in the District Court. *Austrian* v. *Williams,* 216 Fed. (2d), 278. The basis of the reversal was that jurisdiction concerning such allowances was in this Court as the reorganization court, but the Court specifically stated that the propriety of making the allowance was not passed upon.

Thereafter, petitioners in this proceeding, LeBoeuf, Lamb and Leiby, a firm of practicing attorneys in New York who represented Fogarty and Freeman in the New York litigation, applied to this Court for permission to accept an assignment of the claim asserted by Fogarty and Freeman in that proceeding. The basis of the application was *Section 249 of the Bankruptcy Act.* By an order dated December 7, 1955 the application was dismissed on the ground that the rights sought to be transferred or assigned were not claims against or stock of the debtor in the contemplation of the Act. Thereupon petitioners accepted the assignment and filed a petition in this Court seeking compensation.

Counsel have presented exhaustive briefs upon the question for determination and the case has been ably argued orally. My conclusions can be briefly stated.

With respect to the application of *Article 6-A of the New York General Corporation Law,* it is to be borne in mind that this is a Chapter X proceeding. The proceeding in the District Court in New York was incident to the reorganization proceeding in this District and the Court there acquired jurisdiction under the Bankruptcy Act. *Williams* v. *Austrian,* 331 U. S. 647. In view of this it is my opinion that the New York law is not binding upon the reorganization court. Upon the contrary, the rights of petitioners are to be determined in accordance with the principles applicable in Federal Courts without reference to the state law. Petitioners contend alternatively that if they are not entitled to compensation

under the New York law they are entitled to an allowance under *Chapter X of the Bankruptcy Act.* As I understand the provisions of the Act in this respect, as a prerequisite to an award by the reorganization court it must be shown that services so compensated have resulted in benefit to the estate. The facts here are that the petitioners were acting exclusively for the protection of their clients, Fogarty and Freeman. To contend that their services in defending the New York litigation advanced or benefited the reorganization proceeding is unsound reasoning. While it is true the termination of that proceeding was necessary for a final disposition of the reorganization proceeding, I am unable to agree with the contention that counsel for the defendants, seeking to avoid liability for certain claims asserted by the trustees, contributed anything to the reorganization. While due recognition is given to the equitable principles upon which the New York law regarding compensation is based and to the fact that Messrs. Fogarty and Freeman were not held liable for mismanagement of the affairs of the corporation, it is to be borne in mind that the plea of the statute of limitations is the only successful defense which was interposed.

It is my conclusion that the General Corporation Law of New York is not binding upon this Court and that the services performed by the petitioners are not compensable in this reorganization proceeding.

Therefore the petition will be dismissed.

/Sgd./ STERLING HUTCHESON
United States District Judge

June 8, 1956

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 890

RANDALL J. LeBOEUF, JR., HORACE R. LAMB, ADRIAN C. LEIBY, CHAUNCEY P. WILLIAMS, JR., JOHN A. BROUGH, CRAIGH LEONARD, JAMES O'MALLEY, JR., JOHN L. GROSE and HOMER CRAWFORD, Co-Partners, under the firm name of LeBoeuf, Lamb & Leiby,

Petitioners,

v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, a Corporation, Debtor,

Respondent.

PETITIONERS' REPLY BRIEF

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IN THE

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Petitioners,

v.

CARL J. AUSTRIAN, Surviving Trustee of Central States Electric Corporation, a Corporation, Debtor,

Respondent.

PETITIONERS' REPLY BRIEF

Respondent trustee's brief would have the question presented on this petition for certiorari converted into a question of judicial *discretion* of the district judge in the bankruptcy reorganization court in the fixing of an allowance in accordance with the equity powers of a bankruptcy court. That, we submit, is erroneous.

The petition presents the important and unsettled question whether the provisions of the Bankruptcy Act conflict with a state statute which creates a liability for defendants' litigation expenses incurred in the successful

defense of an action brought by the bankruptcy trustees. The decision below was upon the ground that there is such a conflict which precludes the bankruptcy reorganization court from giving effect to such state-created liability.

Admittedly, when the reorganization court has given effect to the state-created liability, then that liability is subject to the equity powers of a bankruptcy court in the same manner and on the same terms that govern the administration in bankruptcy of all liabilities of a debtor. However, that was not, and on the facts, could not have been the basis of the decision below.

The respondent's brief argues (1) that the trial court found that petitioners' assignors "failed to exercise due care and prudence" and that the trustees' action was defeated "on the ground of statute of limitations" (brief, pp. 2 and 3), and (2) that the trial court in New York acted under an "erroneous impression" in interpreting the New York statute (brief, p. 4).

We shall reply to each of these points briefly herein.

POINT I

Respondent's answering brief (page 2) erroneously states that the trustees' action was defeated "on the ground of statute of limitations". The trustee further characterizes the rights of petitioners' assignors as those of "delinquent directors" (brief, pp. 2, 3, 12). The truth is that in the New York action the trustees failed to prove any delinquency and the action resulted in a judgment dismissing the complaint on the merits. The pertinent provisions of the final judgment entered in the New York action in relation to 3 transactions (of 13 alleged

in the complaint) to which the defense of the statute of limitations was considered read as follows:

> "8. In so far as concerns the 'C' and 'I' transactions of the complaint, recovery thereon against defendant Herbert C. Freeman, is barred by the statute of limitations, and the complaint thereon is accordingly dismissed on the merits against said defendant, and except as so adjudged the complaint against defendant, Herbert C. Freeman, be and hereby is dismissed on the merits.
>
> "9. In so far as concerns the 'C', 'I' and 'L' transactions of the complaint, recovery thereon against defendant, James F. Fogarty, is barred by the statute of limitations, and the complaint thereon is accordingly dismissed on the merits against said defendant; and except as so adjudged the complaint against defendant, James F. Fogarty, be and hereby is dismissed on the merits."

Without so stating, but as an attempt to go behind the final judgment, respondent's brief refers to the "C", "I" and "L" claims in which the trial court made tentative findings of liability on the part of petitioners' assignors. But respondent fails to mention that each such finding was made "subject, however, to a consideration of the defense of statute of limitations" (*Austrian, et al., Trustees* v. *Williams, et al.,* 103 F. Supp. 64, at pp. 92, 97 and 101). On consideration of the New York statute of limitations all of the 3 claims were held barred (103 F. Supp. 64, at p. 117).

The decisions of this and other courts hold that statutes of limitations not only require a finding in favor of a defendant who validly raises the defense of such statute, but the statutes also create an irrebuttable factual presumption in favor of such defendants. For example, as

this Court said in *United States* v. *Oregon Lumber Co.*, 260 U. S. 290, at p. 299:

> "Such statutes [of limitations] * * * supply the place of evidence lost or impaired by lapse of time by raising a presumption which renders proof unnecessary. * * *"

The practice of imputing guilt to a defendant claiming constitutional and statutory privileges designed to protect the innocent has been deplored by this Court. In *Ullmann* v. *United States*, 350 U. S. 422, this Court said (at p. 426):

> "* * * This constitutional protection [against incrimination] must not be interpreted in a hostile or niggardly spirit. Too many, even those who should be better advised, view this privilege as a shelter for wrongdoers. They too readily assume that those who invoke it are either guilty of crime or commit perjury in claiming the privilege. * * *"

In a subsequent case, *Slochower* v. *Board of Education*, 350 U. S. 551, this Court held that the claim of privilege should not be used collaterally as a basis to deprive a person of public employment. There, in a discussion which is equally appropriate to the defense of the statute of limitations, the Court said (at pp. 557-558):

> "* * * The privilege against self-incrimination would be reduced to a hollow mockery if its exercise could be taken as equivalent either to a confession of guilt or a conclusive presumption of perjury. As we pointed out in *Ullmann*, a witness may have a reasonable fear of prosecution and yet be innocent of any wrongdoing. The privilege serves to protect the innocent who otherwise might be ensnared by ambiguous circumstances. * * *"

When it is remembered that the claims asserted against petitioners' assignors involved transactions occurring more than 20 years prior to the date of the commencement of the trustees' action in New York with the resulting disability imposed on such assignors in bringing forward proof of the true circumstances, we submit that the assertion of the defense of the statute of limitations was to protect the assignors from the risk of being "ensnared by ambiguous circumstances". The fact that the defense was raised surely cannot be the basis of an inference of misconduct, and it was not so held by the New York trial court which entered the final judgment in favor of petitioners' assignors on the merits and from which the trustees took no appeal.

More important, a reference to the trial court's findings, when stated with the completeness which accuracy requires, which resulted in the final judgment of dismissal on the merits, cannot validly be the basis of an inference of adjudication of liability, which is the opposite of the adjudication as actually entered.

Furthermore, the assertion of the defense of the statute of limitations may not properly constitute a basis of depriving petitioners' assignors of any right available to them by statute under the guise of a so-called exercise of "judicial discretion". This, we submit, would reduce the benefits of statutes of limitations, which have been founded upon centuries of experience in developing a system of justice, to something dishonorable and "a hollow mockery", whereas the contrary is the true purpose of the law.

For the same reasons stated above, the clause on page 14 of respondent's brief that petitioners' assignors "were held guilty of misconduct not only by the Trial Court but by the Reorganization Judge" is false and prejudicial.

As we have shown above, the trial court's judgment of dismissal provides a complete negation and demonstrates the inaccuracy of such statement. Moreover, the reorganization court received no evidence of any misconduct by petitioners' assignors, and thus was not competent to adjudge the assignors *in absentia*.

POINT II

The brief of the respondent trustee criticizes the New York trial court by saying that it acted "under the erroneous impression that it was absolutely constrained by the New York statute to grant" the order which it entered assessing the litigation expenses of petitioners' assignors (brief, p. 4). That is amplified in a footnote at pages 4 and 5 in which reference is made to *Austrian, et al.* v. *Williams, et al.*, 216 F. 2d 278 and *Diamond* v. *Diamond*, 307 N. Y. 263.

The decision in *Austrian* v. *Williams, supra,* was an appeal by the reorganization trustees from the trial court's order granting petitioners' assignors their litigation expenses. The holding of the Second Circuit Court of Appeals was that only the reorganization court in Virginia had jurisdiction because that Court had exclusive jurisdiction over the property of the debtor corporation. As noted in our petition (p. 7), the reversal by the Second Circuit Court of Appeals was expressly stated to be without prejudice to renewal of the application in the reorganization court. But, more important, there was no discussion whatsoever regarding the question whether the New York statute creating the liability for such litigation expenses was discretionary or mandatory.

In *Diamond* v. *Diamond, supra,* both the plaintiff stockholder and the defendant director (and stockholder)

participated in a wrong to their corporation. For that reason a judgment of dismissal was entered. The question was whether the defendant had not been "adjudged" liable for negligence or misconduct within the meaning of Section 64 of the General Corporation Law of New York. A majority of the Court of Appeals held that the judgment of dismissal on the ground stated constituted an exception to the kind of adjudication intended by the statute. There the judgment was founded upon an estoppel against the plaintiff who had knowledge of and ratified and participated in the defendant's wrongful act. In the majority opinion by Desmond, J., it was said (at p. 267):

> "• • • if that word 'adjudged' must be limited in its application to the actual entry of a money judgment against the officer, director or employee, the exception is inapplicable. But 'adjudged' is not so completely a word of art or of such technical meaning, see 2 Words and Phrases, Adjudge, p. 411 et seq. that we cannot seek out the obvious legislative intent. Section 64, changing the common-law rule that each party pays his own lawyer, is to be construed strictly. See, Schwarz *v.* General Aniline & Film Corp. 305 N. Y. 395, 405, 113 N. E. 2d 533, 537. Rewarding faithless officers and directors was no part of its purpose. In all reason and common sense, this defendant has been, in the affirmed findings below, 'adjudged • • • liable for • • • misconduct in the performance of his [her] duties'. • • •"

Referring to the basis for such an interpretation of the word "adjudged", the opinion further stated (at pp. 266, 267):

> "• • • The rule is that, when stockholders are individually estopped from questioning wrongs done

> their corporation, they cannot redress those same wrongs through a suit brought directly by the corporation or derivatively, by themselves, for the corporation. So it was rightly held [in the Court below] here that this plaintiff, estopped by knowledge, ratification and participation, could not, by way of a stockholder's suit, have judgment against her coconspirator, for those wrongs.
>
> "All this should, it seems, be ample warrant for denying to both, or either of these stockholders, payment, out of the corporate till, of their court expenses. * * *"

The *Diamond* case, therefore, presented an unusual and special circumstance which is completely distinguishable from the trustees' New York action. The judgment in favor of the petitioners' assignors was not founded upon estoppel. It resulted from plaintiff trustees' failure of proof or abandonment in respect of 10 of the 13 claims alleged and as to 3 claims the tentative findings of liability were made expressly subject to a consideration of the statute of limitations. On consideration of the presumptions thereby raised, as we have noted, as well as the failure of proof, petitioners' assignors were held entitled to a final judgment of dismissal on the merits.

Except in the estoppel situation in *Diamond* v. *Diamond*, the New York Courts have uniformly held in accord with the trial court in the New York action (*Austrian* v. *Williams*, 120 F. Supp. 900) that Section 64 is a mandatory statutory direction and confers no discretionary power. (See *Dornan* v. *Humphrey*, 278 App. Div. 1010; *Neuberger* v. *Barrett*, 180 Misc. 222, 39 N. Y. S. 2d 575).

The respondent's suggestion (brief, p. 13) that the rights created by the mandatory requirement of the state statute are subject, to a greater extent than other state-

created substantive rights, to the discretionary powers of the bankruptcy reorganization court is without merit. In the petition for certiorari (at pp. 10-18) it has been shown that such holding below was erroneous and that this substantive right created by state law is enforceable in reorganization proceedings in a federal bankruptcy court to the same extent as any other state-created substantive right.

Nothing in the Bankruptcy Act conflicts in any way with the enforcement of the liability against the debtor's estate in accordance with the New York statute. Here no grounds have been shown for the exercise of any discretion in either denying, limiting or otherwise restricting the enforcement of the state-created right to the litigation expenses here involved.

There is no showing that the debtor's estate does not have adequate funds with which to discharge such liability or that the allowance of the state-created right would otherwise be inequitable. The only argument advanced by the respondent trustee for the discretionary power of the bankruptcy court is the erroneous assertion that the final judgment in the trustees' action was solely the result of the defense of the statute of limitations. That assertion has been shown to be contrary to the true facts.

We repeat that neither the final judgment on the merits nor any tentative findings of the trial court create any imputation of wrongdoing on the part of petitioners' assignors which precludes the benefit of state statute in a bankruptcy court.

POINT III

The authorities on which respondent relies are distinguishable and have no application to the question presented herein.

The principal authority cited by respondent is *Vanston Committee* v. *Green,* 329 U. S. 156. There the question involved was the allowance of interest on interest in the distribution of a bankrupt's estate. It was found to be the policy of the bankruptcy law that the allowance of such interest on interest was inequitable during the period of the bankruptcy when payment was suspended by order of the bankruptcy court. As the concurring opinion of Justice Frankfurter shows, such was also the rule of the state law creating the claim in the first instance.

In *Pepper* v. *Litton,* 308 U. S. 295, the question involved the disallowance of a claim based on a judgment procured in a state court on the ground that the procuring of such judgment involved improper conduct and an attempt to defraud a creditor. The disallowance was clearly an exercise of proper equitable jurisdiction of the bankruptcy court.

Brown v. *Gerdes,* 321 U. S. 178, involved compensation for an attorney who had furnished services to the trustee in bankruptcy. Both the state court and the reorganization court held that allowance of compensation of such attorney was exclusively a subject for the reorganization court, pursuant to whose order the attorney was employed.

Leiman v. *Guttman,* 336 U. S. 1, involved services rendered directly in the reorganization proceeding by an attorney for a committee of preferred stockholders. It was held that the bankruptcy court, not the state court, had exclusive jurisdiction to make an allowance payable

out of shares of preferred stock which the committee had placed in escrow for that purpose.

Callaghan v. *Reconstruction Finance Corporation*, 297 U. S. 464, involved the compensation of a court-appointed trustee in bankruptcy, and not the rights of persons who were strangers to the bankruptcy proceeding.

In respect of *Fielding* v. *Allen*, 181 F. 2d 163 (2d Cir. 1950) the respondent, following the same error of the Court below, fails to recognize that there were two separate causes of action: one founded upon state law in respect of which it was held that the state law requiring security for litigation expenses applied; the second, an alleged violation of the Interstate Commerce Act, was founded upon federal law as to which the state statute was not applicable. Here the trustees' action was founded upon state law.

There is likewise error on the part of the respondent in reading the decision of the Court of Appeals for the Seventh Circuit in *In re Granada Apartments, Inc.*, 155 F. 2d 882; cert. den. 329 U. S. 785. There the reorganization trustee brought a plenary action against a former trustee under a mortgage on the debtor's property for alleged mismanagement of the mortgaged property during the period of the mortgage trustee's administration thereof. The mortgage trustee successfully defended the plenary suit and the reorganization court allowed the litigation expenses in the successful defense of such suit.

In *Granada* there was no assertion of a right to compensation under Section 242(1) of the Bankruptcy Act (11 U.S.C.A. §642(1)). The claim against the debtor's estate for expenses incurred in the successful defense of the action brought by the reorganization trustee was founded upon and was upheld as a matter of Illinois substantive case law.

Although the mortgage trustee may have had a lien prior to the transfer of the mortgaged assets to the Chapter X trustee for his services in the management of the trust assets, the fact is that there was no lien at the time of the transfer of the property to the reorganization trustee. The claim of the mortgage trustee was not for management services, but was for legal expenses subsequently incurred in the successful defense of the suit by the Chapter X trustee. The decision was not based on the existence of a lien.

Finally, it is not true that the mortgage trustee was appealing to the reorganization judge either as a matter of "broad judicial discretion" or "as a matter of equity", as asserted in respondent's brief (p. 13). The fact is the mortgage trustee was defending, in a plenary action the reorganization trustee's charges of mismanagement of the mortgaged property. The claim in the suit of the reorganization trustee was founded upon substantive rights created by the law of Illinois, which were held to be without merit, and the subsequent claim of the mortgage trustee for reasonable litigation expenses in the successful defense of the reorganization trustee's plenary suit was also founded upon Illinois substantive law. The claim was not founded upon the provisions of the Bankruptcy Act.

The Court of Appeals for the Seventh Circuit, citing Illinois decisions, held that the mortgage trustee's expenses were enforceable in the reorganization proceedings and that nothing in Chapter X of the Bankruptcy Act was in conflict therewith.

It should also be noted that the mortgage trustee in defending the suit brought by the trustee in reorganization was not a party to the reorganization proceeding.

Petitioners' assignors were in precisely the same relation to the reorganization proceedings here. The mortgage trustee, as is the case of petitioners' assignors, was made a party to a plenary suit brought by a reorganization trustee alleging misfeasance in office during a period preceding the petition for reorganization in bankruptcy.

Thus, when correctly read, we respectfully submit, the *Granada* case is on all fours with the claim for litigation expenses asserted by petitioners' assignors under New York law.

There being no conflict between Chapter X of the Bankruptcy Act and the New York statute, the claim should be heard and determined by the reorganization court in accordance with New York law and payment directed out of the debtor's estate, which is under the jurisdiction of the reorganization court.

Conclusion

Respondent's brief has attempted to deal with the merits of petitioners' claim and in doing so it has not made any showing against petitioners' principal contention, namely, that the Court below has decided an important question of the relation between the Bankruptcy Act and the liability created under state law, which has not been but should be settled by this Court. Likewise, respondent has now shown the absence of any conflict between the decision below and the decision of the Seventh

Circuit Court of Appeals in *In re Granada Apartments, Inc. supra.*

We respectfully submit, therefore, that the petition for certiorari should be allowed.

Respectfully submitted,

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